

Service Date: September 18, 1981

DEPARTMENT OF PUBLIC SERVICE REGULATION  
BEFORE THE PUBLIC SERVICE COMMISSION  
OF THE STATE OF MONTANA

\* \* \* \* \*

IN THE MATTER of the Application of )  
MOUNTAIN STATES TELEPHONE AND )  
TELEGRAPH COMPANY for authority to )  
establish increased rates for telephone )  
service. )

UTILITY DIVISION  
  
DOCKET NO. 80.12.100  
  
ORDER NO. 4786b

APPEARANCES

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FOR THE PROTESTANT:

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FOR THE INTERVENORS:

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Alan L. Joscelyn, Attorney at Law, P. O. Box 1721, Helena, Montana 59601, appearing on behalf of Telephone Answering Services of the Mountain States, Inc.

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FOR THE COMMISSION:

Calvin K . Simshaw, Staff Attorney

BEFORE:

GORDON E. BOLLINGER, Chairman  
JOHN B . DR I SCOLL, Commissioner  
HOWARD L. ELLIS, Commissioner  
CLYDE JARVIS, Commissioner  
THOMAS J. SCHNEIDER, Commissioner

FINDINGS OF FACT

PART A

GENERAL

1. On December 5, 1980, Mountain States Telephone and Telegraph Company (Mountain Bell, Applicant) applied to the Commission for authority to establish increased rates-for telephone service. The tariffs filed with the application would increase revenues from Mountain Bell customers in Montana by \$30,586,000 over those of the test year.
2. On January 19, 1981 a Procedural Order was issued wherein the Commission set dates for intervention, discovery, filing of testimony and hearing on the application.
3. On April 8, 1981 the Commission issued its Order No. 4786 which granted interim relief in the amount of \$3,070,000.
4. On April 27, 1981 the Commission issued Amended Order No. 4786a which deleted standard telephone sets from the re-pricing of vertical terminal equipment for the purposes of generating interim rate relief.
5. During the months of April and May, satellite hearings were held

in the following cities: Missoula, April 14, 1981; Great Falls, April 20, 1981; Lewistown, April 21, 1981; Bozeman, April 27, 1981; Butte, April 30, 1981; Glendive and Miles City, May 6, 1981; Forsyth, May 7, 1981; Broadus, May 12, 1981; and Billings, May 13, 1981.

6. Pursuant to appropriate Notice of Public Hearing, hearings on the General Rate Case, as well as the Variable Term Payment Plan, were held on June 9-12 and June 15-18, 1981 in the Senate Chambers of the State Capitol in Helena, Montana.

7. The office of the Montana Consumer Counsel has participated in the proceedings of this Docket since their inception.

## PART B

### COST OF CAPITAL

8. Three witnesses gave testimony addressing Mountain Bell's cost of capital. Mr. William Danner, Assistant Treasurer-Finance for Mountain Bell and Mr. Eugene Meyer, Manager of the Utility Corporate Finance Department for Kidder, Peabody & Co., testified on behalf of the Company. Dr. Caroline Smith, Senior Consultant with J. W. Wilson & Associates, Inc., testified on behalf of the intervenor, Montana Consumer Counsel.

9. The Company's witnesses advocated an overall cost of capital to Mountain Bell of 12.5 percent. Dr. Smith on behalf of the Consumer Counsel advocated a cost of capital of 10.32 percent. As is discussed subsequently, the Commission finds 10.91 percent to be the overall cost of capital to Mountain Bell and will recognize the same as constituting a just and reasonable rate of return to the Company.

### Capital Structure

10. Mr. Danner and Dr. Smith each proposed a capital structure that they felt was appropriate for the Commission to adopt for rate-making purposes. Mountain Bell is

now a wholly owned subsidiary of American Telephone and Telegraph Company (AT&T). The parent AT&T acquired the minority public interest in Mountain Bell in late 1980. Consequently, both Mr. Danner and Dr. Smith advocated looking to the parent Company or the Bell System when determining a cost of capital for Mountain Bell. Mr. Danner proposed that the Commission utilize a Bell System consolidated capital structure while Dr. Smith recommended application of the direct double leverage capital structure approach.

11. Mountain Bell witness Danner advocated use of the following Bell System consolidated capital structure (Danner Exhibit No. 3-A, Schedule 10).

	<u>Percent</u>
Common Equity	50.7
Preferred Stock	2.8
Debt	<u>46.5</u>
	100.0

The Bell System is made up of the parent holding company - AT&T as well as AT&T Long Lines, a manufacturing arm (Western Electric), a research arm (Bell Labs), and several operating telephone companies including Mountain Bell. The capital structure presented by Mr. Danner represents a consolidation of the capital invested in the system as a whole as opposed to just the capital appearing on the books of either Mountain Bell or AT&T.

12. Because Mountain Bell is now wholly owned by AT&T the only manner in which one can invest in Mountain Bell is to purchase stock in AT&T. Mr. Danner argued that the investor in AT&T stock faces the financial risk contained in the Bell System capital structure and consequently, the Bell System capital structure and its capital costs should be used to determine Mountain Bell's overall cost of capital.

13. As opposed to the Bell System consolidated approach, Dr. Smith on behalf of the Montana Consumer Counsel advocated use of the direct double leverage approach in arriving at an appropriate capital structure for Mountain Bell. Dr. Smith testified that a fair rate of return determination for Mountain Bell should be made in such a

manner as to give recognition to the leveraged capital structure of Mountain Bell and its parent, AT&T. Dr. Smith explained that:

Mountain Bell's equity is wholly-owned and financed by AT&T. Because AT&T finances its OTC investments in part through the issuance of debt and preferred stock, only a portion of the nominal common equity capital shown on Mountain Bell's books is provided by investors who require a return equal to the cost of equity capital. The remainder requires a return sufficient to meet the capital costs of servicing the other capital used by AT&T in financing its investments. Because AT&T's other capital costs less than its equity capital, the return required on Mountain Bell's nominal equity is less than AT&T's equity investors require. In other words, AT&T's use of double leverage affects the cost of capital to Mountain Bell. (Smith, pre-filed testimony, p. 94)

Dr. Smith stated that recognition of AT&T's use of double leverage can be accomplished through either the consolidated capital structure approach advocated by Mr. Danner or the direct double leverage approach which she herself was advocating. However, Dr. Smith specifically recommended the direct double leverage approach because it is based upon costs which reflect Mountain Bell's own circumstances and performance, whereas the consolidated capital structure approach takes all of AT&T's telephone utilities as a single unit.

14. This Commission has been presented with both the consolidated capital structure approach and the direct double leverage approach in each of the last three Mountain Bell general rate cases. In Docket No. 6496, Order Nos. 4389d and 4389g, and in Docket No. 6652, Order No. 4585a, the Commission thoroughly examined and discussed the merits of both approaches. In each instance the Commission chose to adopt the direct double leverage approach. The Commission's application of the direct double leverage approach has been specifically upheld by the Montana Supreme Court in Mountain States Telephone and Telegraph Co. v. PSC, 38 St. Rep. 165 (1981).

15. For the reasons stated in its prior two Mountain Bell orders, the Commission will again adopt the direct double leverage approach; The Commission is of the opinion that the direct double leverage approach allows it to exercise greater regulatory scrutiny over Mountain Bell's cost of service than would adoption of the consolidated capital structure approach. The Commission is concerned that the latter approach assumes that all AT&T owned operating telephone companies have identical capital costs on an overall basis. The equity ratio in the consolidated capital structure approach (50%) is higher than the equity ratio in the direct double leverage approach (48.8%). Also, the debt cost on the consolidated capital structure approach (7.9%) is higher than the debt cost with the direct double leverage approach (7.8%). Although both approaches would yield the same return to AT&T if applied system wide, this indicates that Mountain Bell would be providing a subsidy to other operating telephone companies if the consolidated capital structure approach were applied.

16. If anything the fact that Mountain Bell is now wholly owned by AT&T makes it even more appropriate that direct double leverage should be applied .

17. Implementation of the direct double leverage approach involves recognition of the embedded cost of the long-term debt securities issued by the regulated subsidiary as well as an equity return equal to the weighted cost of capital associated with the parent company's investment in the subsidiary. As an illustration of the mechanics of the direct double leverage approach, assume that parent company "A" owns all of the common equity of subsidiary company "B. " Further assume that each company has a 50-50 debt/equity ratio. The cost of debt to each company is 10 percent. The cost of common equity to the parent company is 15 percent. The subsidiary company's booked common equity is wholly owned by the parent and is therefore not traded in any market. It would be assigned a cost equal to the weighted cost of the parent's capital which was used to finance . the subsidiary's common equity. Therefore, the staring point is the parent company's capital structure and weighted cost of capital:

Parent Company "A"			
	<u>Percent</u>	<u>Cost</u>	<u>Weighted Cost</u>
Common Equity	50	15%	7.5%

Debt	50	10%	<u>5.0%</u>
Total Cost of Capital			12.5%

The parent company's weighted cost of capital would then be adopted as the subsidiary company's cost of common equity. The subsidiary's overall cost of capital would be 11.25 percent determined as follows:

#### Subsidiary Company "B "

	<u>Percent</u>	<u>Cost</u>	<u>Weighted Cost</u>
Common Equity	50	12.5%	6.25%
Debt	50	10.0%	<u>5.00%</u>
Total Cost of Capital			11.25%

- \* The subsidiary's cost of common equity equals the parent's overall cost of capital which was used to finance the subsidiary common equity .

The process can also be expressed on a one-step basis by breaking down the parent's investment in the subsidiary's common equity within the subsidiary's capital structure itself:

#### Subsidiary Company "B"

	<u>Percent</u>	<u>Cost</u>	<u>Weighted Cost</u>
* Common Equity	25	15%	3.75%
Parent's Debt	25	10%	2.50%
Subsidiary's Debt	50	10%	<u>5.00%</u>
Total Cost of Capital			11.25%

- The parent's total investment in the subsidiary equals 50 percent of the subsidiary's capital structure or stated otherwise equals the subsidiary's booked common equity component.

18. Focusing strictly on capital structure considerations, Dr . Smith applied the direct double leverage approach using the following capital structures :

#### Parent AT&T Adjusted Capital Structure

( Exhibit CMS- 22 )

	<u>Percent</u>
Common Equity	82.7
Preferred Stock	3.7
Long-Term Debt	<u>13.6</u>

100.0

Mountain Bell Adjusted Capital Structure  
(Exhibit CMS-26)

	<u>Percent</u>
Common Equity	52.2
Long-Term Debt	<u>47.8</u>
	100.0

Applying Dr. Smith's Patent AT&T capital structure to her subsidiary Mountain Bell capital structure pursuant to the direct double leverage approach would result in a composite double-leveraged capital structure for Mountain Bell as follows:

	<u>Percent</u>
AT&T Common Equity	43.3
AT&T Preferred Stock	1.9
AT&T Debt	7.0
Mountain Bell Debt	<u>47.8</u>
	100.0

19. In arriving at the above capital structures, Dr. Smith made adjustments to both the actual capital structure of the parent AT&T and to the actual capital structure of Mountain Bell. For reasons discussed subsequently, the Commission cannot accept either of Dr. Smith's adjustments. Therefore, in applying the direct double leverage approach in this case the Commission will utilize the actual capital structures of both AT&T and Mountain Bell. This is consistent with the action taken by the Commission in both Docket No. 6496 and Docket No. 6652 (the two prior Mountain Bell general rate cases).

20. The actual capital structure for AT&T is:

	<u>Percent</u>
Common Equity	84.2
Preferred Stock	3.3
Long -Term Debt	<u>12.5</u>
	100.0

The actual capital structure for Mountain Bell is:

	<u>Percent</u>
Common Equity	59.0
Long -Term Debt	<u>41.0</u>

100.0

The common equity component appearing in the actual capital structure of Mountain Bell is in reality composed of the various capital structure components of the parent AT&T. Therefore, it is proper to substitute the 59 percent appearing as common equity in Mountain Bell's capital structure with AT&T's capital structure components at the same level they appear in AT&T's capital structure, but weighted at 59 percent. The double-leverage composite capital structure for Mountain Bell adopted by the Commission is:

	<u>Percent</u>
AT&T Common Equity	49.7
AT&T Preferred Stock	1.9
AT&T Debt	7.4
Mountain Bell Debt	<u>41.0</u>
	100.0

21. A summary of the witnesses' proposals and the Commission's findings concerning adoption of an appropriate capital structure is as follows:

Mr. Danner's Bell System  
Consolidated Capital Structure

	<u>Percent</u>
Common Equity	50.7
Preferred Stock	2.8
Debt	46.5

Dr. Smith's Double-Leveraged  
Capital Structure Using  
Adjusted Capital Structures

	<u>Percent</u>
AT&T Common Equity	43.3
AT&T Preferred Stock	1.9
AT&T Debt	7.0
Mountain Bell Debt	47.8

Double-Leveraged Capital Structure  
Adopted by the Commission

### Using Actual Capital Structures

	<u>Percent</u>
AT&T Common Equity	49.7
AT&T Preferred Stock	1.9
AT&T Debt	7.4
Mountain Bell Debt	41.0

22. Dr. Smith recommended that in applying the direct double leverage approach the Commission should adjust the actual capital structure of AT&T by removing from the common equity component its investment in Western Electric and other non-consolidated subsidiaries. Western Electric is a wholly owned subsidiary of AT&T which is responsible for manufacturing most of the equipment utilized by the operating telephone companies. Dr. Smith argued that AT&T is already receiving an adequate equity return on all of its capital invested in Western Electric at the Western Electric level. Western Electric earns a return from its sales of equipment to Mountain Bell and the other operating telephone companies. Therefore, Mountain Bell ratepayers are indirectly providing a return to AT&T shareholders through the prices that Western Electric charges to Mountain Bell for equipment. Dr. Smith contends that investment in Western Electric should be removed from the common equity component of AT&T's capital structure because it already received an equity return at the Western Electric level. The same rationale would apply to the other less significant non-consolidated subsidiaries .

23. Mountain Bell rebutted Dr. Smith's proposed adjustment by pointing out that it had the same effect as assuming that all of AT&T's investment in Western Electric is financed by AT&T common equity to the exclusion of any debt or preferred stock. This is in direct contravention to the application of the direct double leverage approach to Mountain Bell's capital structure. That approach has the same effect as assuming that AT&T's investment in Mountain Bell is financed by a pro rata combination of AT&T common equity, debt and preferred stock.

24. The Commission agrees with Dr. Smith to the extent that it also perceives a problem relative to the return which AT&T receives indirectly from Mountain Bell ratepayers through Western Electric. The Commission is concerned that Montana ratepayers may be contributing toward a return to Western Electric which incorrectly assumes that the

equity component of Western Electric's capital structure is in fact equity financed. In fact the equity component of Western Electric's capital structure is probably financed by a lower cost combination of AT&T equity, AT&T debt and AT&T preferred stock. If the prices paid to Western Electric by Mountain Bell include an allowance for a return assuming 100 percent equity financing of Western Electric by AT&T then the Commission would have to conclude that those prices are too high and Mountain Bell's rate base is overstated.

25. However, the Commission cannot accept Dr. Smith's proposal for rectifying the situation. Dr. Smith proposes to eliminate AT&T's investment in Western Electric totally from the common equity component of capital structure. The Commission perceives the problem as being one related to rate base rather than capital structure. The Commission is not convinced that it would be appropriate to address the problem by altering the capital structure that will be recognized in determining an appropriate return for Mountain Bell. If the problem is that Mountain Bell is paying prices for Western Electric products that are too high because they include an allowance for a return to Western Electric which does not recognize the effects of double leverage; then the overpayment is ultimately reflected in Mountain Bell's rate base and not its capital structure.

26. The Commission agrees with Dr. Smith's basic proposition that a company's utility ratepayers should not be called upon to help support that company's non-utility affiliates who are presumably involved in competitive activities involving higher risks and higher costs of capital. This has become a growing concern for the Commission as more and more regulated utilities have diversified themselves into non-utility activities. The danger always exists that the non-utility affiliates have a higher cost of capital which drives up the company's overall cost of capital. It would not be fair to ask the monopoly ratepayers to pay that higher cost of capital. The higher cost of capital associated with competitive activities is generally reflected in the need for a "competitive" debt/equity ratio as opposed to a monopoly "utility" debt/equity ratio. Ideally, the Commission would like to be able to isolate and identify those elements of the capital structure necessary to support the non-utility affiliate and eliminate them from consideration for utility rate-making purposes. If the Commission knew that a utility had a non-utility affiliate that required an 80 percent equity ratio for financing, the Commission could eliminate from the utility's capital structure its investment in the affiliate at an 80 percent equity ratio. However, such

identification of the non-utility's financing characteristics is seldom available to the Commission.

27. In the case of AT&T's investment in Western Electric, Dr. Smith has not established at what debt/equity ratio Western Electric would have to be financed if it were to operate on its own without the support of AT&T's monopoly operations. Therefore, it is unclear at what level AT&T's investment in Western Electric should be removed from AT&T's common equity component. The Commission does not find it appropriate to eliminate from AT&T's capital structure its investment in Western Electric at a 100 percent equity ratio.

28. The Commission is concerned that the prices paid to Western Electric by Mountain Bell are not properly accounting for the effects of double leverage. The Commission intends to take a closer look at those prices and their reflection in Mountain Bell's rate base in future proceedings. The Commission does not feel that Dr. Smith's proposed adjustment to AT&T's capital structure is the proper manner in which to address this concern and therefore rejects the adjustment in this case.

29. Dr. Smith also advocated that an adjustment be made to the actual capital structure at the Mountain Bell level. Dr. Smith contended that the return authorized for Mountain Bell's intrastate operations should be lower than Mountain Bell's interstate return in recognition of the risk differences between these two parts of the total company business. Dr. Smith maintained that Mountain Bell's interstate operations are more subject to competition than are its intrastate operations and are therefore more risky. Dr. Smith stated that there are two methods by which one can account for this risk differential. The first is to estimate separate component capital costs for Mountain Bell's capital invested in intrastate operations and then again for its capital invested in interstate operations. However, Dr. Smith chose to implement a second and what she perceived as a somewhat more straightforward approach.

30. Dr. Smith proposed to account for the risk differential by removing Mountain Bell's investment in its interstate operations from its capital structure at a 70-30 equity/debt ratio. Dr. Smith treated 30 percent of Mountain Bell's capital as being

attributable to its interstate operations. She then assigned that portion of Mountain Bell's capital a 70-30 equity/debt ratio because she felt that ratio was typical of competitive industries as a whole. The net effect of Dr. Smith's adjustment would be to alter Mountain Bell's capital structure from one containing 59 percent equity and 41 percent debt to one containing 52.2 percent equity and 47.8 percent debt.

31. Again the Commission agrees with Dr. Smith's basic proposition; that being that where a regulatory commission is confronted with an enterprise which operates in both competitive and monopolized markets, special care must be taken to insure that the higher capital costs associated with the competitive enterprises are not shifted to the firm's monopoly utility markets. However, the Commission cannot accept Dr. Smith's proposed adjustment as being appropriate in this case. The proposed adjustment has the effect of treating Mountain Bell's interstate operations as if they were totally competitive while treating its intrastate operations as if they were not competitive at all. The Commission does not feel that the record in this case supports such treatment. Looking specifically at Montana there is currently no competition in Mountain Bell's interstate operations. However, there is considerable competition in that portion of its intrastate operations related to terminal equipment. It does not appear reasonable to the Commission to treat the interstate operations of Mountain Bell, which are for the most part only potentially competitive, as being risky while at the same time treating the terminal equipment area of intrastate operations, which is in fact actually competitive at this time, as not being competitive. The Commission is of the opinion that consistent treatment of all potentially competitive operations would have the effect of washing out Dr. Smith's proposed adjustment.

32. The Commission is also of the opinion that Dr. Smith's concern regarding the higher cost of capital associated with competitive operations was already addressed to a large extent by Dr. Smith in making her recommendation for an appropriate return on common equity. In making her recommendation, Dr. Smith focussed upon the cost of equity specifically associated with Montana intrastate operations. She had therefore already accounted for what she felt is the riskier operations of the Bell System as a whole. Therefore, Dr. Smith has already to some extent applied the first option she described for accounting for the risk differentials associated with competitive activities.

### Cost of Common Equity

33. Mr. Danner, on behalf of Mountain Bell identified the cost of common equity to AT&T to be in the 16.5 percent to 17.6 percent range. The Company asked the Commission to provide for a 17 percent return on common equity. Dr. Smith on behalf of intervenor Montana Consumer Counsel recognized 13.5 percent to be the cost of common equity that should be utilized by the Commission in this case. The Commission finds the cost of common equity to be 14.03 percent and will grant revenues sufficient to allow a 14.03 percent return on the common equity utilized by Mountain Bell to provide intrastate services in Montana.

34. The Commission finds that the cost of common equity analyses performed by Mr. Danner and Dr Smith are both basically sound. The Commission relied more heavily upon Dr. Smith's analysis and found a cost of common equity closer to her recommendation because she properly attempted to identify the cost of common equity specifically related to Montana intra -state operations. Mr. Danner's analysis is limited to finding a cost of common equity for the Bell System as a whole.

35. It is obvious to the Commission that the steady increase in the cost of common equity to the Bell System is in large part due to inflation. However, it is equally clear from the testimony of Mr. Danner; Dr. Smith and Mr. Meyer as well as the Commission's general knowledge that the major transition which is now occurring in the telecommunications industry is also contributing to the rise in the cost of common equity. The recent FCC Computer II decision, Senate Bill 898, and the pending antitrust suit against AT&T all point toward greatly increased competition for the Bell System in the telecommunications industry. There is little doubt that the imminence of this competition and the increased risks to the Bell System inherent therein are contributing to an increase in Bell's cost of common equity. However, the Commission is not of the opinion that it is appropriate to pass these increased costs onto the Montana intra-state ratepayer at this time.

36. The major impacts of increased competition will be in the areas of message toll and private line service (the impacts of competition in the terminal equipment area have

already for the most part been absorbed). As with the past deregulation of other services it is very doubtful that Montana will suddenly become a hotbed for competition in these areas. Because of the lack of lucrative markets resulting from a sparse population spread over a wide geographic area, the Commission does not foresee any significant influx of competition in intrastate message toll or private line service in Montana. Unlike the Bell System as a whole, Mountain Bell's revenues from Montana intrastate operations will not likely be greatly affected by increased competition. Therefore, the Commission does not perceive any significant increase in the risk associated with Montana intrastate operations.

37. The Commission in its prior Mountain Bell Order (Docket No. 6652, Order No. 4585a) described that when an investor buys AT&T stock a small portion of his investment is being invested in Mountain Bell and a smaller portion yet is in turn invested in Mountain Bell's Montana intrastate operations. It is only this final investment increment that the Commission need concern itself with when determining the cost of common equity. The Montana intrastate ratepayer should only be expected to provide a return on that portion of AT&T common equity that is ultimately invested in Montana. By the same token, the AT&T common stockholder should expect only the return on that portion of his investment that is reinvested in Montana as is commensurate with the risks associated with Montana operations.

38. The Commission agrees with Dr. Smith's contention that because of the relative levels of competition discussed above, the cost of common equity associated with Montana intrastate operations is less than the cost of common equity for the Bell System as a whole. Dr. Smith's analysis properly attempted to account for this differential while Mr. Danner's analysis did not.

39. Both Dr. Smith and Mr. Danner relied primarily upon a discounted cash flow (DCF) analysis in making their cost of common equity recommendations. According to DCF methodology, marginal investors price a share of common stock at a level equal to the present value of expected dividends over the period which they hold the security plus the discounted resale price anticipated upon sale. If dividends are assumed to grow at a constant rate, the discount rate or investor's required rate of return is equal to the dividend yield plus that constant growth rate. The DCF model stated as a formula is:

$$\begin{array}{ccccc} \text{Total Return} & & \text{Current} & & \text{Expected Dividend} \\ & = & & + & \\ \text{to Investor} & & \text{Dividend Yield} & & \text{Growth Rate} \end{array}$$

or

$$\begin{array}{ccccc} \text{Required Return} & = & \frac{\text{Expected Dividend}}{\text{(Price of Common Stock)}} & + & \text{Expected Dividend} \\ & & & & \text{Growth Rate} \end{array}$$

40. Because Mountain Bell common stock is no longer traded on the open market, both Mr. Danner and Dr. Smith utilized market information for AT&T common stock in order to perform their DCF analyses. The starting point in a DCF analysis is the calculation of a current dividend yield. The dividend yield is equal to the expected dividend divided by the price of the common stock.

41. In his DCF analysis Mr. Danner utilized a dividend yield in the range of 9.5 percent to 10 percent. (Darner, direct, p. 24) Dr. Smith adopted 10 percent as the dividend yield in her analysis. (Smith, direct, p. 47) Because Dr. Smith's dividend yield also falls within the range of Mr. Danner's, the Commission finds that 10 percent is an appropriate dividend yield to be used in a DCF analysis of the required return on AT&T common equity.

42. The second or "growth" component of the DCF analysis is defined by Mr. Danner as being investor's expected growth in earnings or dividends. Mr. Danner determined that a growth rate of 5 percent to 6 percent was a reasonable expectation on the part of investors. Combined with his range for dividend yield this gave Mr. Danner a DCF market return in the range of 15 percent to 16.6 percent. (Darner, direct, p. 25)

43. Dr. Smith defined the "growth" component of the DCF analysis as being the long-term dividend growth expectation of investors. Dr. Smith arrived at a growth rate in the range of 3 percent to 4 percent. Combined with her 10 percent dividend yield component, this gave Dr. Smith a DCF required return in the range of 13 percent to 14 percent. (Smith, direct, P 53)

44. As was mentioned earlier, a primary difference in the analyses of Mr. Danner and Dr. Smith was the latter's attempt to arrive at a cost of capital associated with Mountain Bell Montana intrastate operations as opposed to Bell System operations as a whole. The Commission finds that such a distinction is not only appropriate but necessary. Dr. Smith's 3 to 4 percent growth rate is specifically applicable to a Bell System operating telephone company (Transcript Vol. IV, p. 782). Dr. Smith stated that if she had merely determined a growth rate for AT&T as a whole she would probably have arrived at a rate in the range of 4 percent to 5 percent.

45. The Commission finds that in attempting to focus as much as possible on the cost of capital specifically related to Montana intrastate operations that Dr. Smith's Exhibit CMS-12 gives the best indication of the appropriate growth rate to be used in a DCF analysis. Exhibit CMS-12 lists historical growth in earnings, dividends and book value for the periods 1964-1979 and 1969-1979 for Bell System operating companies that have had publicly traded common stock. The Commission chooses to rely on that exhibit for a couple of reasons. First, it shows data for operating companies alone which has the effect of eliminating the impacts of Western Electric, Bell Labs, AT&T Long Lines and other non-operating company activities that would be reflected in AT&T data. Second, it shows data for periods that reflected the situation before the onslaught of significant competition and the resulting higher risks. As was discussed earlier, the Commission does not perceive such higher risks associated with competition as arising in Montana intrastate operations for quite some time. This can be compared to Mr. Danner's analysis which relies primarily upon very recent trends in AT&T data meaning that it includes the impacts of the pending influx of competition and the non-operating company activities of the Bell System.

46. Mr. Danner criticizes Dr. Smith's DCF analysis for relying too heavily upon historical book value growth rates. (Danner, rebuttal, p. 6) Mr. Danner states that historical growth in book value will understate future growth in a period when returns on equity are higher than in the past. Dr. Smith criticized Mr. Danner's DCF analysis for focusing too much upon growth in earnings. (Smith, direct, p. 54) Both witnesses seem to be in agreement however, that dividend growth rates are crucial in any DCF analysis. Therefore, the Commission will concentrate on dividend growth rates as they appear in Exhibit CMS-12.

47. The average for historical growth in dividends for the companies listed on Exhibit CMS-12 for the period 1964-1979 as 2.88 percent. The average for the period 1969-1979 was 4.03 percent. Although it is necessary to look into the past to some degree to avoid the impacts of increased competition, the Commission does not feel that it is appropriate to go all of the way back to 1964. The Commission finds that the 4.03 percent average growth rate in dividends for the period 1969-1979 is the best indicator of investors' expected rate of growth relative to Montana intrastate operations. Therefore, the Commission adopts 4.03 percent as the growth component of a DCF analysis in this case.

48. The Commission recognizes that the information derived from Exhibit CMS-12 does not give a perfect indication of the cost of common equity specifically relative to Montana intrastate operations. It is impossible to completely isolate and identify such a narrowly defined cost based upon the market information available. However, the Commission finds that based upon the record before it in this case, the information in Exhibit CMS-12 and the 4.03 percent average growth in dividends in particular comes the closest to identifying such a cost.

49. Combining the 4.03 percent growth component with the 10 percent dividend yield found in Finding No. 41 leaves the Commission with a DCF required return of 14.03 percent. The Commission will recognize 14.03 percent as the cost of common-equity in this case.

50. Mr. Danner supported his DCF findings with a bond-equity spread analysis and a comparable earnings analysis. Again, Mr. Danner's methods are sound if one is attempting to identify a cost of common equity for the Bell System as a whole. Dr. Smith also performed a comparable earnings analysis in which she focused upon returns for low risk monopoly operations similar to Montana intrastate operations and opposed to operations of the Bell System as a whole which are not entirely monopolistic. Dr. Smith's comparable earnings analysis corroborates the 14.03 percent cost of common equity found by the Commission through the DCF method.

51. Mr. Meyer also testified on behalf of Mountain Bell. Mr. Meyer did not calculate or sponsor a specific cost of common equity. He gave a broad description of the capital markets in which AT&T must operate and concluded by stating that the 17 percent return on common equity proposed by the Company would not meet the needed market premium to book value under current market conditions. (Meyer direct, pp. 52-53) The Commission finds the same shortcoming in Mr. Meyer's testimony that it did in Mr. Danner's. Mr. Meyer has made no attempt to determine anything other than the cost of common equity for the Bell System as a whole. The Commission agrees that a 14.03 percent return on common equity would probably not be appropriate if it were applied across the board to all of the Bell System's operations. However, the Commission does feel that 14.03 percent is appropriate when applied to the Montana intrastate operations which this Commission regulates and which Montana intrastate rates are supporting.

52. Mr. Danner contended that the DCE analysis merely identifies the "market" cost of common equity. Mr. Danner advocated that a .5 percent to 1.0 percent market-to-book adjustment be made to allow for issuance costs and market pressure. This would have the effect of adding .5 percent to 1.0 percent to the return found using the DCF analysis. Mr. Meyer concluded that a 20 percent premium is necessary to account for issuance costs and market pressure.

53. Dr. Smith did not include an explicit allowance for issuance expense or market pressure in making her return recommendation. Dr. Smith pointed out that to the extent that investors anticipate future public offerings, that anticipation is reflected in the price of common stock and therefore is included in the dividend yield portion of the DCI results. Dr. Smith also maintained that market pressure can be either positive or negative depending on the company involved and the timing of the offering. In any event, she maintained that a market-to-book adjustment is necessary only if a company regularly engages in significant new common stock issuances in the open market. AT&T issued 16.5 million new shares of common stock in June, 1981, during the hearing of this case. However, as Dr. Smith pointed out (Transcript Vol. IV, p. 947), that issuance increased common equity by only 2 percent and was the first such issuance in several years. Dr. Smith contended that the issuance did not produce any additional return requirement for AT&T. The Commission agrees.

54. The Commission finds 14 .03 percent to be the cost of common equity associated with investment in Mountain Bell Montana intrastate operations. The Commission finds that a return of 14.03 percent is just and reasonable and commensurate with the risks and revenues associated with such an investment. The Commission feels that in so finding it has adequately considered the inflationary pressures so evident in today's capital markets . The 14.03 percent represents the highest return on equity ever granted by this Commission in a major utility case.

#### Cost of Preferred Stock

55. Mr. Danner assigned 7.8 percent as the Bell System consolidated cost of preferred stock. (Darner, direct, p. 30) Dr. Smith found the cost of preferred stock to be 7.6 percent at the AT&T parent level (Smith, pre-filed testimony, p 101) Neither witness challenged the other's finding in this regard. Because the Commission has again chosen to apply the direct double leverage approach in this case, the cost of preferred at the AT&T level is the relevant number. The Commission finds AT&T's cost of preferred stock to be 7.6 percent.

#### Cost of Debt

56. Mr. Danner found the cost of debt to be 8.0 percent for the Bell System consolidated. (Darner, direct, p. 30) Dr. Smith found the cost of debt to be 6.5 percent at the AT&T parent level (Smith, pre-filed testimony, p. 101) and 8.1 percent at the Mountain Bell level (Exhibit CMS-1). Application of the direct double leverage approach requires the assignment of a cost of debt at both the parent and subsidiary level. Therefore, the Commission will adopt and apply Dr. Smith's costs of debt.

#### Overall Rate of Return

57. In order to develop the appropriate rate of return for Mountain Bell using the direct double leverage approach; the 14 .03 percent cost of common equity, the 7.6 percent cost of preferred stock, and the 6.5 percent and 8.1 percent costs of debt for AT&T and

Mountain Bell are applied to their respective components in the capital structure set forth in Finding No: 20. Properly weighting each cost of capital with the proportion at which it appears in the capital structure results in an over all cost of capital of 10.91 percent:

<u>Capital Structure Component</u>	<u>Percent of Total</u>	<u>Cost Rate</u>	<u>Weighted Cost</u>
AT&T Common Equity	49.7%	14.03%	6.97%
AT&T Preferred Stock	1.9	7.6	.14
AT&T Debt	7.4	6.5	.48
Mountain Bell Debt	<u>41.0</u>	8.1	<u>3.32</u>
Overall Cost of Capital			10.91%

58. By granting a 10.91 percent overall return on capital in this case the Commission has recognized and properly accounted for all of the costs of capital associated with investment in Montana intrastate operations including an adequate return to the ultimate common equity holder. The 10.91 percent overall return will allow for a 14.03 percent return to the AT&T common stockholder (for that portion of his investment that ultimately supports Montana intrastate operations ) after allowing for the payment of Mountain Bell's debt, AT&T's debt and AT&T's return to preferred stockholders.

## PART C

### REVENUES, EXPENSES AND REVENUE REQUIREMENT

59. Mr. Shriver sponsored exhibits and testimony which detail the cost of service and rate base amounts which support the revenue increase of \$30,586,000 requested by the Applicant. Mr. Shriver presented evidence on the financial condition of the Applicant with emphasis on the adverse effects of inflation and inadequate rate relief. Also noted was the higher productivity of Montana compared to Mountain Bell. As he did in the last docket Mr. Shriver has proposed normalizing capitalized costs including the interest component of interest charged construction. Mr. Shriver made two proposals relating to changes in depreciation, recommended expensing rather than capitalizing station connections. At page 29 of his pre-filed direct testimony Mr. Shriver requests that this Commission grant an attrition adjustment in the amount of \$2,000,000.

60. Mr. George F. Hess a witness for MCC presented testimony and exhibits on the cost of service and the proper rate base. Mr. Hess prepared a series of seven schedules which culminate with the change in revenues required to produce the rate of return recommended by Dr. Smith. Mr. Hess found that after completing his adjustments the Applicant had excess revenues in the amount of \$792,000.

#### Test Year

61. The test year comprised of the 12 months ending June 30, 1980, is found by the Commission to be a reasonable period within which to measure Applicant's utility revenues, expenses and returns for the purpose of determining a fair and reasonable level of rates for telephone service.

#### Pensions

62. At page 2 of his direct testimony MCC witness George Hess described an adjustment made to pension expense. The basis of the revision was an update performed by Mountain Bell. Since this revision is not contested, the Commission accepts it and finds the reduction of pension expense in the amount of \$250,000 appropriate.

#### Legislative Advocacy

63. MCC proposes to eliminate \$3,000 of legislative advocacy expense which had been charged above the line by the Applicant. There is no evidence in the record that this expense results in a benefit to the rate payers of the Applicant. The reduction by \$3,000 in legislative advocacy is accepted.

#### License Contract Services

64. License Contract services are centralized services provided by AT&T's General Department and Bell Telephone Laboratories to AT&T's Long Lines Department, Western Electric and the Bell Operating Companies. AT&T's General Department provides

advice and assistance to the Long Lines Department and to the Operating Companies.

Advice and assistance is provided in the areas of:

. . . general engineering, plant, traffic, operating, commercial, accounting, patent, legal, administrative and other matters pertaining to the efficient, economical and successful conduct of the Licensee's business. AT&T also agrees to provide advice and assistance in any financing required in the extension, development or improvement of the Licensee's telephone system, including aid in securing funds on fair terms and assistance in marketing the securities of the Licensee. (Donat, pre-filed, pp. 15, 16)

65. Bell Labs provide Research and Systems Engineering (R&SE) to the Bell Operating Companies and Specific Development and Design (SD&D) services to Western Electric. R&SE is provided in all fields related to telecommunications. This work cost \$366 million in 1979 and comprised 34 percent of Bell Lab's work. (Donat, pre-filed, p. 7)

Specific Development and Design work performed for Western Electric is product related and performed to benefit Western as an equipment manufacturer. This work, the cost of which was \$495 million in 1979, is directed and paid for by Western Electric and included by Western as a cost to be recovered in the sales price of its products. ( Donat, pre-filed, p . 9 )

66. The Agreement under which AT&T is to provide License Contract services to the Mountain States Telephone and Telegraph Company was entered into on August 5, 1930. From that date to 1948, payments were limited to 1 ½ percent of local and toll revenues less uncollectibles. From 1948 to 1974 the limitation was lowered to 1 percent; in 1974 the limitation was raised to 2 ½ percent. Although the limitation currently remains at 2 ½ percent, the actual amount billed is a pro rata allocation based, inter alia, upon factors developed in the Separations Manual and includes a return on investment equal. to the prior

year's Bell System consolidated rate of return excluding the contribution of Western Electric.

67. Part VI of Exhibit 5-A, Exhibit of Richard R. Donat, provides the allocated expenses for the year ending June 30, 1980. This exhibit shows that \$52,149,875 was allocated to Mountain Bell. Of that amount \$3,706,320 was allocated to Montana with \$2,240,188 allocated to the intrastate operations. License Contract expense calculated as 2 ½ percent of local and toll revenues less uncollectibles would have been \$2,623,075. (Per figures from Shriver, Exhibit No. 4-A, Appendix A, p. 8)

68. Montana Consumer Counsel witnesses Wilson and Buckalew address two issues of concern regarding License Contract expense: 1) the amount of license contract expense properly allowable, and 2) the amount of allowable expense that should be characterized as competitively related and therefore not the responsibility of regulated monopoly service ratepayers.

69. Witnesses Wilson and Buckalew have argued that certain License Contract expenses should be disallowed on the grounds that the Company failed to provide documents supporting the expenses. These documents include 100 percent of the Case Authorizations and 10 percent of the Budget Decision Packages. Case Authorizations (CA's) are the budget documents used by Bell Labs to determine the annual amount of money to be spent on each activity while Budget Decision Packages (BDP's) provide the same function for AT&T's General Department. As Dr. Wilson has noted:

Although they reflect budget and expenditure authorizations rather than actual dollars spent, these documents [CA's and BDP's] represent the only disaggregated (project-by-project) cost data available which relates expenditures to activity at AT&T's General Department and Bell Telephone Laboratories. (Emphasis added) (Wilson, pre-filed p. 37)

The amount of expense associated with License Contract activity not disclosed by the Company is \$882,138. (Exhibit J.W.-4 and Exhibit A.B.-6)

70. The Company has argued, as it did in the previous general rate case, that the information contained in these documents is proprietary in nature. Mr. Donat addresses this issue in his rebuttal testimony:

Q. WHY HAVE CASE AUTHORIZATIONS AND BDP'S NOT BEEN MADE AVAILABLE IN MONTANA?

A. By their nature, Case Authorizations describe the direction and effort of information of this nature would be valuable to Mountain Bell's competitors. In the absence of a protective agreement to avoid public disclosure of this information (which appears to be in conflict with Montana Statutes), Mountain- Bell and AT&T have declined to make the cases available.

Q. HAVE CASE AUTHORIZATIONS AND BDP'S BEEN MADE AVAILABLE IN OTHER STATES WHERE PROTECTIVE AGREEMENTS HAVE BEEN ESTABLISHED?

A. Yes, in the last 18 months, Case Authorizations have been made available in 23 regulatory jurisdictions. In completed proceedings in those jurisdictions there has been no total disallowance of R&SF. as proposed by Dr. Wilson. In fact of the 54 total jurisdictions that review license Contract expenses only 5 have made any form of disallowance or deferral of R&SE expenses.

71. Because 1) there is no protective order regarding these documents in Montana, 2) witnesses Wilson and Buckalew have been provided with these documents in other jurisdictions (Transcript, p. 1205; Buckalew, prefiled direct, p. 13), 3) when provided with these documents Messrs. Wilson and Buckalew's recommendation was not to disallow but to assign a portion to competitive products (Transcript, p. 1214), the Commission finds that a disallowance of these expenses is not appropriate.

72. Witnesses Wilson and Buckalew have also recommended disallowing \$319, 822 of expense associated with AT&T's antitrust suits. As Dr. Wilson argues:

A. The cost of AT&T's antitrust defense should be borne by the Company's stockholders, and they, in turn, should hold the Company's management responsible for the incurrence of these costs. Ratepayers in the State of Montana and, indeed, in other jurisdictions are not responsible for the anti-competitive actions in which AT&T has engaged and which are now giving rise to public and private antitrust suits against AT&T throughout the country. Nor, for that matter, would it be appropriate for AT&T to later attempt to include the amount of the antitrust judgments and settlements now being entered and negotiated in its future rate cases. To make such costs

a burden of telephone service subscribers would not only constitute an unfair allocation of expenses properly attributable to the stockholders who retained the managers who engaged in these actions, but it would also serve as a further anti-competitive cross-subsidy from basic telephone subscribers -- this time to fund AT&T's court battles which are aimed at the continued frustration of competition. (Wilson, pre-filed p. 43)

73. In his rebuttal testimony Mr. Dwyer argues that the cost of litigation is a legitimate business expense and must be recognized as such:

A. Mountain Bell is named in a number of antitrust actions . Legal costs associated with these cases are proper and reasonable expenses, similar in nature to other legal expenses incurred during the normal course of business. Litigation is a means of resolving business controversies. To deny these costs on the basis of some assumed outcome is to prejudge the case and is contrary to our legal tradition. The outcome of these antitrust suits could have an impact on the way the Bell operating companies, including Mountain Bell, conduct their business. Defense of these suits on a centralized basis is not only proper because of our involvement, but also practical since each Company only pays a fraction of the total cost. (Dwyer, rebuttal p. 8)

74. In arriving at a decision regarding the appropriate allocation of antitrust litigation expense the Commission has considered not only the legitimacy of this expense but the beneficiaries as well. The Commission recognizes that litigation expense is a necessary and ongoing expense involved in the conduct of any business, but to place the full burden of this expense on the backs of the ratepayers suggests that they in turn are the sole recipients of the benefits of litigation action. This is clearly not the case in the instant proceeding in that stockholders, too, stand to benefit from these actions. Because both groups, stockholders and ratepayers, are potential recipients of the benefit of litigation the Commission finds it reasonable to divide the cost of this activity equally between the two groups. As a result \$159,912 of antitrust activity expense is disallowed.

75. The final disallowances recommended by Messrs. Wilson and Buckalew include \$40,173 of License Contract expense associated with "other Holding Company activities" and \$12,351 associated with construction work in progress. The other Holding Company activities are outlined in Exhibit A. B. -6 of Mr. Buckalew's pre-filed exhibits and include Corporate Image Activity, Western Electric & International Activity, Lobby Type Activity and Charitable Contributions Administration. The Commission finds that these activities provide no benefits that inure directly to the ratepayer and, therefore, disallows them. In keeping with longstanding Commission policy the expense associated with construction work in progress is also disallowed. Total disallowances associated with License Contract expense are \$212,436. The remaining allowed expense is \$2,027,752.

76. The second issue pertaining to License Contract expense, the extent to which these costs can be categorized as "competitively related," will be discussed in a following section on rate design.

#### Business Information Systems (BIS)

77. In his pre-filed testimony Applicant's witness Dwyer explains the nature of the Business Information Systems Agreement:

This is an agreement between Bell Telephone Laboratories and the Operating Telephone Companies dated July 1, 1967. It provides for the centralized development and maintenance of electronic data processing and business information systems and programs for use by the operating companies in the operation of the telephone business. The primary reason for the BIS agreement is to take advantage of the benefits of centralized development of major computer programs and systems for application in the Bell System. (Dwyer, pre-filed p. 33)

78. Business Information Systems services provided by Bell Telephone Laboratories are allocated to AT&T's Long Lines Department and the Bell Operating Companies on a pro rata basis on the average percentage of gross plant and operating expenses.

- A. The method of allocation used for Bell Laboratories' BIS development costs, as provided for in the Agreement, is based on the relationship of the average of gross plant and operating expenses of the participating companies. That is, each participating company's share of these costs is based annually on the average of (1 ) the percentage of its total gross telephone plant to the aggregate gross plant of all the participating companies as of the end of the preceding year, and (2) the percentage of its total operating expenses to the aggregate operating expenses of all the participating companies during the preceding year.

Schedule 2 of my Exhibit contains the BIS allocation percentages and their calculation for 1979 and 1980.

- Q. WHY ARE GROSS PLANT AND OPERATING EXPENSES USED AS THE BASES FOR THE ALLOCATION ?

- A. Gross plant and operating expenses are used as the allocation bases because the benefits to the participating companies from BIS implementation and use are closely related to these two items. The two primary goals of BIS are improved plant utilization and lower operating expenses. Thus, companies with larger plant investments or more expenses stand to benefit more from BIS systems than companies with less plant investment, or smaller expenses. Therefore, it is reasonable to use these two items as a measure for determining the allocation percentage. (Stevenson, rebuttal pp. 10-12)

An example of the allocation procedure is contained in Schedules 2 and 3 of Exhibit No. 14-A(R), Fred L. Stevenson Rebuttal Exhibit.

79. Total Montana Intrastate BIS expense is determined to be \$270,400 as set forth in Schedule 1 of Exhibit 6-A, Joseph T. Dwyer Exhibits.

80. In addressing BIS expense Montana Consumer Counsel witness

Buckalew points out that:

. . . sound regulation requires that costs be charged to those customers who benefit from their incurrence. In that regard, there are a number of BIS projects whose costs are being charged currently to Montana ratepayers, but which have not been implemented in the State of Montana. (Buckalew pre-filed p. 27)

Through Data Request BIS-1, Mr. Buckalew was able to determine that of the thirty-one (31) BIS projects nine (9) major systems (BANCS, BISCUS, BOSS, SSFS, DICSO, SONDS, TABS, TSPS/DR and TTMI) have not been implemented in Montana. These systems have an associated expense of \$66, 615.

Responsible ratemaking requires the establishment of a tenable benefit/ cost relationship. The ratepayer should not be required to pay for benefits not yet received. A full allowance of the BIS expenses claimed by the Company would be a violation of this fundamental tenet of regulation. The Commission therefore finds it appropriate to disallow the \$66, 615 of expense associated with BIS projects not yet implemented in Montana. The granted level of expense for BIS services is \$203,785. Regarding further filings of BIS expense, the Company is directed to provide detailed documents listing each BIS project for which the Company has been billed, the amount of expense associated with each project, an indication of whether or not the particular project has been implemented in Montana, and if implemented a full explanation of how that project benefits the Montana ratepayer.

### Separations Issues

81. Separation issues arise as a result of the necessity to allocate the plant, revenues and expenses associated with jointly used services between the interstate and intrastate jurisdictions. The current procedure for making these allocations is presented in the February, 1971 Separations Manual, published by the NARUC-FCC Cooperative Committee on Communications. The Manual provides for separations procedures on the "station-to-station" basis (Φ11. 11) . Furthermore, separations are made on the "actual

use" basis, which gives consideration to relative occupancy and relative time measurements ( $\Phi$ 11. 211).

82. Because in many instances the Manual serves more as a general guide to separations rather than an explicit and detailed procedure, there often arise instances in which the appropriate treatment of a particular service offering is not well defined. Such is the case with the allocation of interstate Foreign Exchange Service (FX) and interstate Federal Telecommunications System (FTS) minutes of use as pointed out by Consumer Counsel witness Buckalew in his pre-filed testimony.

83. Mr. Buckalew argues his point by first describing the nature of these two service offerings:

- A. Foreign Exchange service permits a local subscriber access to a remote (foreign) exchange without incurring toll charges. For instance, a Denver subscriber can have a Helena telephone number by subscribing to interstate Foreign Exchange service. This provides the Denver subscriber full access to the free calling local exchange areas in Helena. Any call placed by this Denver subscriber requires the same use of Helena exchange plant (i. e., local switching facilities, access line and station equipment) as would an interstate toll call placed by a Denver resident.

The Federal Telecommunications System (FTS) allows federal agencies in Montana to obtain long distance interstate service by utilizing an extensive system of interstate leased private lines. Since Mountain Bell counts the minutes of use of these leased switched private lines as local exchange, the associated costs of the station equipment, outside plant and switching equipment utilized to provide the federal government with such services is borne entirely by the local exchange ratepayers. (Buckalew, pre-filed p. 75)

- 84. He continues to state that both services are clearly interstate in nature and

. . . given both the recent climate of the FCC's rulings on the access charge and its call for the convening of a joint board to modify the Separations Manual to reflect such switched private line minutes of use in the determination of the SLU factor (FCC Order 80-95), such an adjustment seems more than reasonable. (Buckalew, pre-filed p. 78)

85. Using Company-provided data on the number of such lines and estimates of their minutes of use Mr. Buckalew calculates the effect of assigning FX and FTS minutes of use to the interstate arena (Exhibit A. B . -19, p 1 of 1 ) The estimated per line minutes of use were arrived at in the following manner:

I estimated average use per termination to be between 3,240 and 7,000 minutes per month. The FCC has reported average use of exchange lines as being approximately 3,240 minutes per month in the Bell System territories (FCC Memorandum Opinion and Order, Docket No. 78-371, April 12, 1979, §19). Since FX and FTS services are economical only with constant and heavy circuit use, their use must be in excess of this average for all services. Data from other jurisdictions support this conclusion, as they suggest usage levels in excess of 5, 000 minutes per month and up to as much as 7,000 minutes per month for such circuits. To assure conservatism, I utilized an estimate of 4,500 minutes of use per month in my calculations. (Buckalew, prefiled p. 80)

86. Mr. Paul M. Hartnman provided rebuttal testimony in separations issues for the Company. He argues that:

The service is an end-on-end private line service provided under two tariffs. The interstate private line-link is furnished under an interstate tariff, FCC 260. The local portion is provided under local exchange tariffs. That FS/CCSA is private line service can be determined by reference to the Separations Manual definition of "message service" which shows that private line service is simply not covered by that definition. That being so, it follows that separations principle applicable to private line services are not

based upon the application of SPF, which under the Separations Manual apply only to message services. (Hartman, pre-filed rebuttal pp. 3, 4)

And continuing:

The current separations procedures assign the costs of this service in accordance with the dual nature of the tariffs governing the offering. The interstate private line portion (furnished under the FCC 260 tariff j is directly assigned interstate; the remaining portion (furnished under the one-party business portion of the Local Exchange Tariff-Montana) is categorized as message service. Message service costs are assigned to the operations based on SPF. Since the tariff governing the message service portion of the FX offering is local exchange, so too must be the minutes of use. (Hartman, pre-filed rebuttal p. 6)

However, under cross-examination Mr. Hartman acknowledges that simply because a particular service is tariffed under local exchange does not mean that all of those minutes of use must necessarily be assigned to local exchange:

Q. Just because an item or cost is governed by local exchange tariff, that doesn't mean that all of its minutes are going to be assigned to intrastate operations, does it?

A. You are saying that you offer a service that's under a local tariff and will the cost be assigned a local?

Q. Well, let's take an example. Let's take inside wiring.

A. Okay.

Q. How are these costs apportioned?

A. They are apportioned based on something called the subscriber plant factor which is an inflated subscriber line usage, let's say. In Montana's case it's 3.57 times actual usage, so it's about 40 percent of inside wiring that's assigned to interstate. The reason it can get assigned to interstate that way is because services that use inside wiring are under a variety of tariffs. They are under the Interstate Message Tariff, the State Toll Message Tariff, and the Local Tariff, and on these jointly used facilities you must assign them based on -- on this case on SPF, which is what the manual asks. And it is covered by tariffs.

Q. But inside wiring itself is governed by local exchange tariff.

A. Installation is in the cost, I guess, but the tariff reads that it's from station to station, so it says that the rates for interstate are set and they cover the cost from the originating telephone to the terminating telephone. And you've got to go through -- at least use the inside wiring to get to the telephone, so it's covered by the interstate tariff, and therefore a part of the cost must be allocated to interstate. (Transcript, pp. 1098-1100)

87. When asked his personal opinion regarding Mr. Buckalew's methods in making the minutes-of-use adjustment Mr. Hartman responds: "My position on them is that they make sense. I will be perfectly honest with you." (sic) (Transcript, p. 1088) And furthermore, when asked AT&T's position on the minutes-of-use adjustment Mr. Hartman responds:

Q. Can you tell us if AT&T is recommending that FX/CCSA minutes of use which count the exchange minutes of use at open ends of interstate, if FX/CCSA as interstate, are they proposing to do that?

A. Yes, they are so proposing to do that.

Q. Are all of those exchanges that I just described, are they included in Mr. Buckalew's recommendation?

A. Yes, they are.

Q. The main changes that Mr. Buckalew proposes are therefore now being proposed by both Mountain Bell and AT&T in Joint Docket 286; is that correct?

A. Yes. And they have been proposed in the past by AT&T. (Transcript, p. 1087)

88. Based on the evidence, the Commission finds Mr. Buckalew's adjustment to be appropriate. There is no reason why all of the local interstate exchange minutes-of-use associated with interstate FX service should be allocated to local exchange simply because a portion of the plant involved in providing that service is governed by local exchange tariffs. As has been shown, inside wiring is also governed by local tariff yet its cost is partially apportioned to the interstate arena. There is nothing substantial in the record to indicate that these two service offerings should be treated differently in the separations process. Bolstering this opinion is the attitude of AT&T itself as well as the opinions of several other state jurisdictions. The record is replete with instances in which the same treatment offered herein by Mr. Buckalew has been implemented or is under contemplation for implementation in other jurisdictions (see Transcript pp. 1079-1106). The effect of Mr. Buckalew's adjustment is to reduce intrastate book cost by \$3,292,000, reduce rate base net plant by \$2,688,700 and reduce test year expenses by \$1, 637, 700.

89. The second adjustment made by Mr. Buckalew is in regard to the Company's assignment of investment to Station Equipment-Category 2-Private Line Services. This assignment is made by multiplying an appropriate average unit cost of station apparatus by the number of interstate private line loops. The controversy arises in the determination of the appropriate number of loops. A loop is defined to be "A pair of wires, or its equivalent, between a customer's station and the central office from which the station is served. " (Emphasis added) (Separations Manual, p. 94, )

90. Mr. Buckalew argues that an insufficient amount of station equipment has been allocated to Category 2 because the Company failed to count those instances in which no physical wire pair is used for the loop and cites three instances in which a physical wire pair is not required to provide a loop.

91. In his pre-filed rebuttal testimony Mr. Hartman responds:

By Mr. Buckalew's own admission, his three examples of "loopless loops" are instances "where a physical wire pair is not necessary. " Obviously, a "loopless loop" does not fit the definition of "a loop per the Separations Manual. Therefore, Mountain Bell is following the Manual by not counting these "loopless loops" as loops in determining the loop count ratios.  
(Hartman, pre-filed rebuttal p . 9 )

92. From this one could interpret the Company's interpretation to be that a physical wire pair is required for a loop to exist. However, under cross-examination Mr. Hartman confides that that may not necessarily be the case:

Q.. Mr. Hartman, just one point of clarification The separations manual in defining a loop says it's a pair of wires or its equivalent. Do you know what it means when it says "or its equivalent"?

A. What I think as an equivalent is it's a radio channel.  
(Transcript p. 1096)

93. The Commission finds that the terminology "or its equivalent" expressly provides for those instances in which a physical wire pair is not required and accepts Mr. Buckalew's adjustment in this area. The effect of the adjustment is to reduce intrastate book cost by \$98, 500, reduce rate base net plant by \$87,700 and reduce test year expenses by \$59,100.

94. The final adjustment recommended by Mr. Buckalew is in regard to administrative changes delineating the means to be used when measuring separations

factors. The adjustment would increase intrastate expense requirements for calendar year 1979 by \$40, 000. In that the NARUC has requested that these changes be held in abeyance (see Hartman, pre-filed rebuttal, p. 10) the Commission finds it inappropriate to make these changes at this time.

### Straight Line Equal Life Group Depreciation

95. The Applicant has proposed a new depreciation method to replace the straight line vintage group method. The new method, straight line equal life group (SLELG), is said by the Applicant to have several advantages; (1) better match capital consumption with capital recovery, (2) increase internally generated funds and cash flow, and (3) reduce the impact of inflation and the risk of obsolescence. The annual depreciation rate under the vintage group method is based on the estimated average service life of the total group. Using the equal life group method, a separate depreciation rate is computed for each vintage. In his original pre-filed testimony Mr. Shriver indicated that, if accepted, SLELG would be phased in over a three year period beginning in 1981 as follows: first year-outside plant, second year-central office equipment, third year-all other. In Mr. Shriver's rebuttal testimony on page 36, the proposal to change to SLELG is updated to include the 1982 increment of the first and second year phase in.

96. MCC witness Hess recommends that SLELG be rejected in the present Docket as the Commission has not approved it. A 1943 report of the NARUC Committee on Depreciation and a petition for reconsideration by NARUC of an FCC order which approved SLELG are the basis of Mr. Hess' recommendation. An examination of both references is in order.

97. The 1943 report quoted by Mr. Hess does not address the assertion of the Applicant that SLELG or the "unit summation plan" is more accurate than the vintage group method. In fact, the quoted sections from the 1943 report indicate only that detailed information is needed for the "unit summation plan. " Automated depreciation records, prepared by computer allows much more flexibility than there was in 1943.

98. NARUC in its petition for reconsideration complains the there are disadvantages to changing to SLELG. The mere fact that a change in methods will increase depreciation expense is not in and of itself a valid reason to reject it. Increased internal generation of funds in a number of respects is beneficial for ratepayers.

99. After weighing the evidence presented in this case, the Commission accepts SLELG as being more accurate and a better measurement of depreciation for this Docket. However, the Commission does agree with MCC that monitoring depreciation under SLELG will be much more difficult. Unfortunately, the Commission and staff are without the same computer capabilities that have made it possible for the Company to move to SLELG depreciation. The Commission will therefore require complete access to the Company's data base so that it can monitor developments in the depreciation area. Hopefully, in the future the Commission will acquire its own computer capabilities that will allow it to independently access and evaluate depreciation information.

The Commission approves the first year phase in of SLELG. The proposal of Mr. Shriver to also recognize the second year of the phase in at this time is rejected as it would invalidate the test year matching principle. The proposal of Mr. Shriver to also recognize the second year of the phase in at this time is rejected as it would invalidate the test year matching principle.

#### Depreciation Re-prescription

100. On September 22, 1980 (after the close of the test period in this Docket), Mountain Bell and the other Bell Operating Companies filed with the Federal Communications Commission (FCC) a request for a re-prescription of depreciation rates for all parts of Accounts 231, Station Apparatus and 234, Large PBX to be effective January 1, 1981. Three main factors led to this filing according to Mountain Bell; (1) currently prescribed average service lives are too long, (2) the currently used Whole Life procedure does not produce full capital recovery, and (3) three years is too long a period to evaluate proper depreciation rates. The Applicant "requested that in the event that the depreciation rate changes are adopted by the FCC prior to the conclusion of this Docket that the Commission incorporate the same in the calculation of Mountain Bell's cost of service. "

101. MCC resists the Applicant's re-prescription adjustment (1) because the Commission has not approved the new rates and (2) the very serious question of who is to bear the cost of deficiencies in depreciation reserves if any.

102. The Commission has not yet met with the FCC to determine new depreciation rates for terminal equipment. Since at the time of drafting this order the FCC has not adopted the depreciation rate changes the Commission rejects the adjustment. The removal of \$1, 610, 000 in depreciation expense is approved by the Commission.

#### Pro Forma Interest Expense

103. MCC proposed a reduction in tax expense based upon a calculation of pro forma interest expense. The Applicant agrees that an interest expense adjustment may be correct, however, Mountain Bell did not agree with the way Mr. Hess computed the interest adjustment. Mountain Bell notes that Mr. Hess did not include job development investment tax credits in developing the weighted cost of debt. The Applicant feels that the adjustment may result in the loss of JDIC.

104. The Commission has in the past accepted the pro forma interest calculation offered by MCC. In this Docket no persuasive evidence has been offered showing that the adjustment is improper. The treatment of JDIC in the calculation of MCC is accepted as a proper balancing of shareholder and ratepayer interests. The Commission accepts the methodology sponsored by MCC and reduces State Income Taxes in the amount of \$43,000 and Federal Income Taxes in the amount of \$273, 000.

#### Expensing Station Connections

105. In the Federal Communications Commission's Phase II Final Decision and Order in Docket 19129 it was decided that the present accounting system should be modified so as to place the burden of all costs associated with station connections on the causative ratepayer as opposed to the present system which places the burden on present

and future ratepayers. The station connection account-Account 232 of the Uniform System of Accounts reflects predominantly the cost of labor and various loadings that arise as a result of "churning." Churning occurs when an existing customer moves, or the Company offsets the loss of one customer with the gain of another. In 1979 the Bell System installed approximately 36 million telephones and removed approximately 31 million telephones for a gain of 5 million telephones. Also, 77 percent of the telephones installed during the five-year period ending December 31, 1974 did not represent increased service, but was due to churning.

106. FCC Docket No. 79-105, First Report and Order addressed this problem. Prior to the order the FCC had suggested expensing all items presently capitalized in Account 232. However, most of the commentors noted that the majority of costs charged to Account 232 were the result of the churning of station apparatus (i. e., telephone sets) which generates costs relating to the inside wiring portion of the station connection. AT&T has determined that drop and block wire costs were only about 5 percent of the ongoing investment, and only approximately 15 percent of the total embedded investment in the account. (In Montana approximately 32 percent of total embedded investment is in drop and block wire simply because there is not near the frequency of a single drop and block line serving a large multi-unit dwelling that is found in larger metropolitan or more urban areas of the country.) Therefore, the costs associated with frequent moves in our transient society are paid for by everyone, not just the person who is moving.

107. As another commentor pointed out, the inside wiring portion of Account 232 is largely under the influence of the customer where as the drop and block wire may not be and may be viewed rather as a permanent and integral part of the switched network. Upon consideration of these facts the FCC agreed that the drop and block wire should continue to be amortized and directed all subject carriers to assign their investment in Account 232 into two subclasses: "Station connections-inside wiring" and "Station connections-others. "

108. The Central Telephone and Utilities Corporation noted that under existing rate-making the costs of these activities, whether capitalized or expensed, are assigned to the interstate and intrastate segments via jurisdictional separations. The result is that the

causative ratepayer still is not bearing the burden of his decision but is passing off approximately 25 percent or more of the costs to the general body of interstate MTS and WATS ratepayers.

109. The National Telecommunications and Information Administration (NTIA), noticing the same thing, suggested that the only appropriate approach to insuring that the cost causer bear the burden is to de-tariff inside wiring altogether. The FCC concurred in that opinion, stating that the notion of detariffing comports with deregulation in the face of competition, and has proposed the scheduling of proceedings to address the issue of detariffing in the future.

110. In the interim, the FCC has decided that the extraordinary rate of growth in Account 232 cannot continue unchecked for even a short while and has concluded that expensing, coupled with appropriate tariff action by the state commissions, would, for the most part, impose this cost on the cost causative customer. As a result the FCC had ordered all subject carriers to expense to account 605-"Installations and repairs of station equipment-the inside wiring portion of station connections, beginning October 1, 1981, on either a "flash-cut" or "four-year phase-in" basis; and to amortize the existing embedded investment in Station connections-inside wiring over a ten year period. Carriers have been allowed to assume that the depreciation reserve balance for this subclass is zero, and may make such accounting changes retroactive to any earlier date in calendar year 1981.

111. In line with the FCC's proposal Mountain Bell has filed for authority to expense station connections and has requested implementation on the flash cut rather than the phase-in basis. Preliminary analysis indicates that through 1995 the phase-in approach in Montana would cost \$4.5 million more, in nominal terms, than the flash cut approach. Using present value methods and discounting at 12 percent, the phase-in approach requires \$16,213,000 of revenue cumulative through 1995; the flash cut approach requires \$16,088,000 cumulative. While the phase-in approach requires smaller initial annual revenues, the cross over comes after only three years with the revenue requirement under phase-in being larger in the fourth year than in any year under the flash cut. In the seventh year cumulative revenue requirements are small under the flash cut approach and remain so for the remainder of the years.

112. The revenue requirements were established by assuming a zero balance in the depreciation reserve account for Station connections-inside wiring, and using near term growth parameter projections of 8 percent for 1981, 10 percent for 1982 and 1983, which were then trended on a straight line basis through 1995.

113. Montana Consumer Counsel witnesses did not specifically reject the concept of expensing station connections. Mr. Hess reversed the Company's adjustment in this area stating that the issue may be more appropriately addressed in a separate docket centering on rate design.

114. The Commission, after a careful consideration of this issue, is convinced that expensing station connections is an appropriate action to relieve the ratepayer body of the ever increasing burden resulting from the nature of this account. Because the investment in account 232 is not considered to be affected by wear, tear or obsolescence, but is kept at initial condition through maintenance, the net plant account is never reduced via accumulations to the associated depreciation reserve account. This action, coupled with increasing levels of churn and high current levels of interest rates, places an ever increasing burden on the general ratepayers. The expensing of prospective station connections coupled with a ten-year amortization of the embedded investment in the inside wiring portion of account 232 will provide the needed relief in this area. The Commission accepts the Company's proposal to expense station connections on a flash cut basis .

#### 1981 Wage Increase

115. In his rebuttal testimony Mr. Shriver asked the Commission to consider some post-test year wage increases. (Shriver, pre-filed rebuttal testimony, p. 37) According to Mr. Shriver, effective August 9, 1981, non-management employees would receive cost of living increases tied to the Consumer Price Index. Also a salary increase was granted to management and technical employees on April 1, 1981. The test year value of both increases amounts to \$3,357,000 and generates an additional revenue requirement of \$3,568,000. (Shriver, rebuttal exhibit 5(R), p. 9)

116. The \$3,568,000 revenue requirement increase associated with the 1981 wage increases was not included in the Company's original application for \$30,586,000 in rate relief . In situations such as these the Commission traditionally will recognize adjustments to test year expenses if they are known and measurable and if they occur within 12 months after the end of the test year. The Commission is reluctant to look any further beyond the test year because it would jeopardize the proper matching of expenses and revenues. The purpose of the test year is to allow a matching of revenues with the expenses that will be necessary to generate those revenues over the same time period. Mr. Shriver countered with the argument that the wage increases would be in effect before the Commission issues its final order in these proceedings. Mr. Shriver contended that if no allowance is made for the increases, the Company will immediately begin to incur a revenue deficiency of \$3,568,000 annually .

117. The Commission will not consider these wage increases in this proceeding. The Commission finds that the test year, plus 12 months general limitation on adjustments should be observed here. The Commission is concerned that introduction of adjustments and increased revenue requirements at the rebuttal stage of testimony may not allow all parties adequate opportunity to discover and respond. The Commission is also unsure as to whether Mr. Shriver's calculations properly account for changes in the Company's Montana employee level and changes in employee productivity which may have occurred since the close of the test year.

118. However, the Commission is also cognizant that the wage increases are expenses that the Company will be incurring by the time this order is issued. Therefore, the Commission will initiate a separate proceeding to consider the wage increases on an expedited basis. The scope of that proceeding will include review of Mr. Shriver's calculations, current employee levels, employee productivity, and consideration of how any recognized revenue deficiency should be recovered.

#### Amortization of Excess Balance

119. Mr. Hess makes several adjustments to deferred federal and state income taxes. The Applicant has normalized state income taxes for both liberalized depreciation

and vested vacation pay. Given reasonable assumptions as to growth Mr. Hess indicates that there is no compelling reason to defer these tax benefits.

120. In his rebuttal testimony Mr. Shriver states that the adjustment to deferred state income tax should be rejected because

it violates the whole intent of Congress, legislative history, accounting principles as applied to accelerated depreciation, regulatory treatment in Montana since its inception, and in my judgment, Montana tax regulations.

121. After studying the proposals of both parties, the Commission accepts the adjustments to deferred state taxes proposed by Mr. Hess. Unless it can be shown that tax reductions will not continue year after year, there is no reason to defer the benefits of these tax reductions. The Commission accepts the removal of current deferred state income taxes and the five year amortization of accumulated deferred state income taxes.

122. In addition to the adjustments discussed above, Mr. Hess recommended a two-year amortization of the deferred federal income taxes accumulated at tax rates in excess of 46 percent.

123. The Applicant resists this adjustment, claiming that to return this excess accrual could place in jeopardy the company's right to use accelerated depreciation. Mr. Shriver makes a proposal that nothing be done until revised treasury regulations are issued. The Commission does not agree that the return to the ratepayer of the excess tax accrual will cause the loss of accelerated depreciation. With regard to the Maine decision referred to by the Applicant (Docket No. 80-142) this Commission is not bound by the decisions of other state regulatory authorities. To defer return of taxes which were accrued at a higher rate than is currently required is unfair to ratepayers. The Commission accepts the two year amortization of the excess balance in the amount of \$325,000.

Attrition

124. Consistent with the presentation made by Mountain Bell in Docket No. 6652, the Applicant has again asked the Commission to consider an attrition adjustment. In Docket No. 6652 this Commission rejected an attrition adjustment in part because it was not precisely measurable. At Mr. Shriver's Exhibit. 4-A an attempt is made to quantify the erosion of the earnings of Mountain Bell. Mr. Shriver recommends an attrition allowance of \$2, 000, 000 .

125. MCC does not agree with the requested adjustment for attrition. While showing an earnings decline, MCC points out that the calculation ignores increases in income and subscriber growth. Also MCC points out that traditional price relationships may change in the new competitive environment .

126. The Commission, consistent with past decisions in this regard, rejects the Applicant's proposed attrition adjustment. The Commission does not set rates in a setting removed from the real world. Ratepayers as well as utilities are beset by rising prices. Attrition adjustments have consistently been rejected by this Commission because their use directly contributes to future inflationary pressures.

#### Normalization of Capitalized Costs

127. Mountain Bell has proposed comprehensive income tax normalization for the following areas; the interest component of interest charged construction, and employee benefits, pension costs, and social security taxes related to the construction of telephone plant. The Applicant seeks through normalization to spread the tax benefits over the life of the plant. In addition, the Applicant proposed that tax-timing differences that have been flowed through to earnings at the level which existed for the year ending June 30, 1979 be frozen. This plan according to Mountain Bell will further benefit the consumer by reducing the need for outside capital.

128. MCC rejects the adjustment as in the opinion of Mr. Hess there is no evidence that future growth will abate. This indicates that the tax savings currently available will continue without interruption for a number of years into the future.

129. After a review of the positions by all parties on this issue the Commission rejects the normalization adjustment for the reasons noted in Order No. 4585a. While Mr. Shriver's adjustment did mitigate the harshness previously mentioned in that order, the reality of increasing telephone plant makes normalization too great a burden for present ratepayers. The Commission approves the reduction of Federal Taxes in the amount of \$23,000 and State Taxes in the amount of \$4,000.

#### Full Normalization of Deferred Taxes

130. MCC witnesses Hess and Wilson presented testimony and exhibits on the subject of complete normalization of deferred taxes. Traditional utility regulation has allowed deferred taxes as a current expense for rate-making purposes. Deferred taxes arise as a result of the use of accelerated depreciation for tax purposes and straight-line depreciation for expense and rate base purposes. MCC argues that this method causes ratepayers to pay for deferred taxes which are not paid currently. In addition, ratepayers are asked to pay the current tax expenses associated with creation of the deferred tax reserve.

131. Dr. Wilson describes full normalization in his direct testimony at page 10:

Full normalization with respect to deferred taxes consists of adjustments to tax expenses for rate-making purposes so that those deferred taxes which are not paid currently are reflected as if they were a current expense on the income statement and as an addition to the deferred tax reserve on the balance sheet. Also, taxes currently attributable to the taxable income from which the deferred tax reserve addition was obtained are deducted from current revenue on the income statement and a corresponding non-cash income allowance for taxes on deferred credits (AFTDC) is recorded as a deferred charge on the balance sheet.

132. As ratepayers benefit from the deduction of accumulated deferred taxes from rate base for rate-making purposes, Dr. Wilson feels that it would be consistent to make a rate base addition for the accumulated deferred tax charge.

133. Mr. Shriver testified that the adjustment is a violation of treasury regulations:

I understand Section 1.167 of the regulations to mean that for Mountain Bell to use accelerated depreciation methods, cost of service may be no lower than it would have been if the company had used straight line depreciation .

134. The Commission agrees in principle with the concept of "full normalization." However, the effect of this adjustment on the Company's use of accelerated depreciation is uncertain. Until a revenue ruling has been received, the Commission cannot accept it. For the purposes of this proceeding the MCC full normalization adjustment is rejected.

135. The Commission finds that Mountain Bell is entitled to \$11,687,000 of additional annual gross operating revenue as follows:

SCHEDULE 1  
MOUNTAIN BELL  
MONTANA INTRASTATE  
TWELVE MONTHS ENDING JUNE 30, 1980  
(000 )

	Adjusted Per Company	Adjustments	Accepted By Commission
1. Local Service Revenues	\$ 55,743	\$	\$ 5,743
2. Toll Service Revenues	41,745		41,745
3. Miscellaneous Revenues	7,600		7,600
4. Uncollectibles	(487)		(487)
5. Total Operating Revenues	\$104,601		\$104,601
6. Maintenance	22,006		22,006
7. Depreciation	13,744	(1,610)	12,134
8. Traffic	10,493		10,493
9. Corrunercial	14,409		14,409
10. Revenue Accounting	2,054		2,054
11. Other General	6,510		6,510
12. Operating Rents	1,538		1,538
13. Relief and Pensions	10,059	(250)	9,809
14. General Services & Licenses	2,225	(212)	2,013
15. Unclassified Adjustrment		(1,767)	(1,767)
16. Total Operating Expenses	\$ 83,038	\$(3,839)	\$ 79,199
17. Federal Income	116	1,320	1,468
18. State Income	861	(363)	503
19. Amortization of Excess Deferred Taxes		(905)	(905)

20. Social Security	2,934		2,934
21. Other	8,272		8,272
22. Total Operating Taxes	\$ 12,183	52	\$ 12,272
23. Net Operating Income	9,380		13,130
24. Interest Charged Construction	1,187	(1,187)	-0-
25. Miscellaneous Deductions	62	(62)	-0-
26. Net Operating Earnings	10,505		13,130
27. Average Rate Base	174,900	(1,309)	173,591
28. Rate of Return	5.36%		7.56%

SCHEDULE 2  
MOUNTAIN BELL  
REVENUE DEFICIENCY AT PRESENT RATES  
MONTANA INTRASTATE  
TWELVE MONTHS ENDING JUNE 30, 1980  
(000 )

1. Rate Base	\$173,591	
2. Recommended Rate of Return	10.91%	
3. Recommended Return		\$18,938
4. Adjusted Net Operating Income		13,130
5. Income Deficiency		\$ 5,808
6. Tax Multiplier		2.0252
7. Revenue Deficiency		\$11,762

In its application the Company made provision for increased independent company toll settlements. The Commission recognizes that because of rate increases granted by this order, Mountain Bell will incur additional expenses in its toll settlement procedures with independent telephone companies. The Commission finds that the Company is entitled to revenues to offset toll settlements expenses. It is expected that the additional revenues needed shall be approximately \$2,125,898 annually. Thus, Mountain Bell's revenue deficiency including toll settlements is \$13,887,898.

PART D

RATE DESIGN

136. The telecommunications industry is currently in a state of transition from being fully regulated to being a combination of regulated and deregulated services. This transition has been prompted by the emergency of competition in several areas of telecommunications including private line service, message toll service and vertical terminal equipment. In Federal Communications Commission Docket No. 20828, the Second Computer Inquiry, the FCC directed the American Telephone and Telegraph

Company to establish a fully separate subsidiary for the provision and sale of terminal equipment. The Commission set March 1, 1982 for the initial switchover date and initiated a separate hearings process to determine if the switchover should include the transfer of embedded equipment or pertain solely to installations after the March 1, 1982 date. To date no decision has been reached regarding this latter issue.

137. Because the new subsidiary will be completely de-tariffed and operating in a "competitive" environment it becomes imperative that regulators base rates on cost to prevent subsidization of the competitive service offerings by regulated monopoly ratepayers. Subsidizations of this nature not only place an excessive burden on the regulated monopoly ratepayer but also introduce an anti-competitive element into the competitive arena by allowing pricing below cost to prevent a reasonable opportunity for entry into the market.

The new subsidiary will consist primarily of Western Electric Corporation, AT&T's manufacturing arm, to include the necessary transfer of marketing and managerial personnel and information . In the interim, the cost of developing technology and providing marketing and managerial information associated with terminal equipment must not fall on the local exchange ratepayer. As Dr. Wilson notes, the costs associated with a particular product or service must fall on that service if pricing is to be efficient:

In a market economy it is critical that the prices that are established reflect, to the extent possible, the real costs of providing additional quantities of each good and service (i. e., marginal costs). If prices do reflect these economic costs, then resources will be allocated among the different industries (and production rates for these industries will be determined )so as to produce the composition of goods and services that will tend to maximize aggregate economic satisfaction. (Wilson, pre-filed direct, p. 39)

138. It has been noted that Bell Labs provides Western Electric with Specific Design and Development services and the Operating Companies with Research and Systems Engineering services, as outlined in the Case Authorizations; and that AT&T's

General Department provides the Long Lines Department and the Operating Companies advice and via the Budget Decision Packages. While the cost of providing SD&D services is recouped directly through the Montana Fully Distributed Cost method of pricing, witnesses Wilson and Buckalew indicate that a substantial portion of the cost of providing advice and assistance and R&SE services is competitively related but being placed on the local basic exchange service subscriber through the residual pricing process:

For example, costs associated with the development of AT&T's proposed competitive nationwide data system called Advance Communication System (ACS) have been included in the rates for residential local exchange service. These costs relate to a specific service and should be included in the rates for that service, not the rates for local exchange service.

Q. Is Mountain Bell's treatment of its License Contract expenses appropriate?

A. No. Because Mountain Bell prices its local basic exchange services on a residual basis, and costs caused by other service offerings, but not assigned to those offerings, find their way into the revenue requirement of local basic exchange service subscribers. (Wilson, pre-filed direct, pp . 33, 34 )

My associates and I have examined the Budget Decision Packages of each department in AT&T's General Department. These show that significant costs can be directly attributed to competitive services. In our analysis of the Budget Decision Packages, we examined each Package to determine whether the work was performed primarily for the benefit of competitive services or products. The determination was based on an examination of the general description of each activity, the results of the activity and the expected benefits of the activity. (Wilson, pre-filed direct, p . 40 )

Q. HAVE YOU BEEN PROVIDED WITH THESE DOCUMENTS IN OTHER JURISDICTIONS?

A. Yes. In other jurisdictions, I have been provided with a sample of the Case Authorizations. Using that sample, I was able to determine that, at the minimum, 47 percent of Bell Labs' license contract casts were, indeed, related to competitive products and services. I was also able to determine from the Case Authorizations presented, that at least 11 percent of the license contract activity of Bell Telephone Laboratories is related to data services, that 13 percent is related to toll services, that 12 percent is related to terminal equipment services and that 11 percent is related to competitive products or services without specific identification of the particular service. (Buckalew, direct, pp. 13, 14)

Dr. Wilson also addresses the effects of subsidization on competition:

The present method of financing product related R&D through license contract charges results in specific product costs (which provide particular benefit to Western Electric and the users of specific Western products) being recovered through rates charged to the general body of Bell ratepayers. Further, no manufacturer other than Western Electric has the opportunity to fund its development and marketing research in a manner such as this. This funding method gives Western a decided anti-competitive advantage over other manufacturers of telecommunications equipment in that only Western does not have to recover these kinds of expenses through the prices it charges. (Wilson, direct, p . 49 )

139. Although in this docket the Company refused to provide the Case Authorizations in the absence of a protective order, these documents were supplied to Messrs. Wilson and Buckalew in other jurisdictions. Their analysis of these documents in other jurisdictions in part leads to the amount of these costs associated with competitive equipment. The full amount of License Contract costs associated with competitively related items was established during the course of cross-examining Dr. Wilson (see Transcript, pp. 1204-1218). These costs include 47 percent of the undisclosed Bell Labs Case Authorizations (\$355,715; Tr., p. 1213), an approximation of the amount of the undisclosed Budge. Decision Packages relating to competitive products (\$100,000; Tr., p. 1214) and certain AT&T General Department expenses (\$185,496; Tr. p. 1215), for a total allocation to competitively related products of \$641,211.

140. The issue of the amount of License Contract expense appropriately designated as "competitively related" is uncontested by the Company. The intent of the Company appears to be a collection of the License Contract expense regardless of the source of revenue generation.

141. In light of the current regulatory complexion as regards telecommunications (i. e., competition combined with deregulation) the Commission finds it appropriate and necessary to insure that exchange ratepayers are not required to pay for the creation of AT&T's competitive and fully separate subsidiary. Consequently, should the revenue requirement found in this order not be met prior to establishing revised local exchange rates, and after having considered any local exchange rate design changes, an additional \$641,211 of revenue will be placed on competitive services (i.e., terminal equipment, private line, toll or some combination thereof) before again considering the matter of revising local exchange rates.

142. Finally, in this age of high speed data transmission and advanced computer technology the Commission finds it difficult to believe that AT&T is unable to track costs on the basis of their relation to either competitive or non-competitive service offerings. In the absence of a compelling argument setting forth the reasons why such a tracking procedure cannot be implemented, the Commission directs the Company to provide a listing of all Case Authorizations and Budget Decision Packages utilized during the test year in Montana, accompanied by an explanation of how that CA or BDP benefits Montana ratepayers, and the extent to which the CA or BDP is competitively related; such information to accompany all future general rate case applications.

#### Directory Assistance

143. The Company has proposed to begin charging for Directory Assistance beyond an initial five-call allowance per residential or business line per month. Other details of the proposal are presented below from page 1 of 1, Schedule 5, Exhibit No. 10-A sponsored by Company witness Lou F. Marquardt.

#### DETAILS OF PROPOSED DIRECTORY ASSISTANCE SERVICE CHARGING PLAN

Five calls per Residence or Business line per month at no charge.

Maximum of two number requests per call.

\$.20 for each call (placed to 1-411 or 1-555-1212) over the 5-call allowance .

\$ .40 for each call placed to an operator.

No charge for Interstate Directory Assistance.

No charge for calls from:

Physically or Visually Handicapped persons  
Hospitals  
Motel/Hotel  
Coin Telephones

Five calls per Private Branch Exchange (PBX) Trunk per month at no charge .

Five calls per six Centrex stations per month at no charge.

Five calls per month per Special School Centrex dormitory main telephone .

144. Studies indicate that from 1969 to 1979 Montana has experienced a 77 percent growth in DA calls, with a corresponding growth of 152 percent in operator weekly wage rates. It is the wage element that makes DA an expensive service to provide. Further studies indicate that most customers will be unaffected because over 94 percent of the combined residence and business customers, excluding coin trunks, hotels, motels and hospitals, make five or fewer calls per month. (Marquardt, direct, p. 19) The indication is that all users are being required to pay for the indiscreet use of this service by a relatively small handful of large users .

145. The proposed charge is \$.20 per call after a monthly call allowance of five calls. One reason for the allowance is to provide for those instances when a customer does not have the directory for a distant town in Montana. In cases where customers would have a continuing need to place calls to other cities in Montana, the Company will furnish directories for those cities at no charge. (Marquardt, direct pp. 20, 21 )

146. The cost study supporting the proposed DA charging plan is located in Section 1, Directory Assistance, Exchange Services, in Volume V of the Company's Cost Filing Package. That study shows that incremental revenues are estimated to be \$216,854; incremental costs are estimated to be a negative \$340, 069 for a total incremental contribution of \$556, 933 . The largest component of the incremental cost savings is a reduction of \$629,343 in operator wage expense.

147. Mr. Buckalew presented testimony on Directory Assistance charging for the office of the Montana Consumer Counsel. While Mr. Buckalew concedes that the Company's plan is generally appropriate, he also considers it to have a couple of flaws:

Q. WHAT ARE THOSE FLAWS?

A. The Company has not presented a study showing the costs of providing directory assistance calls. They have arbitrarily chosen the 20 cents per call

charge and have not presented any cost data to support that charge. While the 20 cent charge is now a common Bell System proposal, where such proposals have been supported by cost information, the direct cost per call of providing directory assistance has been only about 14 cents. However, since the 14 cents includes only direct costs, the 20 cent rate proposed by the Company appears to be generally reasonable. The major flaw in the Company's proposal is therefore in the implementation of the tariff for directory assistance charging.

Q. WHAT DO YOU RECOMMEND WITH RESPECT TO THE IMPLEMENTATION OF THE TARIFF FOR DIRECTORY ASSISTANCE CALLS?

A. First, I recommend that the Company's proposal to charge 20 cents per call for directory assistance be implemented only after customers are fully informed that there is a cost associated with directory assistance so that there is an effective economic incentive to refrain from making these calls. Also in this regard, I recommend that the Company be ordered to implement directory assistance charging at 20 cents per call with no free calls, and that a separate line item on each customer's bill be established in order to display to the customer each month what his charges are for directory assistance. In order to provide an incentive, an economic signal to customers, each call must be charged. Moreover, because the Company will be charging 20 cents per call to cover costs that are already included in exchange service rates, I recommend that exchange rates be reduced by the estimated amount of those revenues. (Buckalew, direct, pp. 51,,52)

148. The Commission finds the Company's proposal acceptable and finds the \$.20 charge per call after five calls reasonable. Mr. Buckalew's suggestion of charging for every call is rejected. The Company's proposal strikes a workable balance between the provision of "free" calls in special circumstances and placing the burden of payment on excessive use. Mr. Buckalew has also expressed a concern for informing the general body of ratepayers about the \$.20 charge. The staff will undertake to issue a news release concurrently with the dispatch of this order in the hope that this concern along with others will be alleviated.

149. The first year annual net revenue increase from this plan is estimated to be \$216,864. Associated with this increase in revenue is \$340,069 in cost savings. Because a cost savings can be viewed as an offset to the found revenue requirement the total net effect of implementing the plan is a \$556, 933 offset to the found revenue requirement.

150. Concurrent with implementing the Directory Assistance charging plan the Company will issue a bill stuffer setting forth the details of the plan. The stuffer should place special emphasis on the availability of credit cards for sight handicapped individuals. Because sight handicapped individuals would have the same difficulty reading a bill stuffer as reading a directory, it may be more appropriate to address this portion of the stuffer to friends and relatives of sight handicapped individuals.

### Centrex

151 Mr. Richard D. Reinking presented testimony on pricing Centrex service for the Company. Centrex service is essentially private branch exchange service provided for very large customers. The two major rate elements of this service are the exchange network access, which is the equivalent of private branch exchange trunks, and the intercommunication.

152. Centrex cost studies are included in the Cost Filing Package and are based on the "avoidable cost" concept. In his testimony Mr. Reinking explains avoidable costs and explains why these are the relevant costs in the pricing of obsolete services:

In the case of obsolete equipment with no reuse value, we have already spent the money necessary to buy all equipment that is needed to provide this service. The spent money cannot be recovered. It is "sunk." Therefore, the future costs of replacing this equipment is not relevant. Instead, only the ongoing expenses associated with that service are relevant to pricing the product. We often refer to these costs as avoidable costs since the amount of the expenses is all that we could avoid in the future. Thus, avoidable costs are the relevant prospective costs for pricing of obsolete services. (Reinking, direct, p . 26 )

He continues to explain the pricing philosophy used in the pricing of Centrex service (nonaccess):

Q. UPON WHICH COSTS HAVE YOU BASED YOUR PRICES FOR CENTREX SERVICE?

A. We have based our proposed prices for Centrex upon the avoidable cost. We propose that the price for Centrex should be approximately 10 percent above these costs. We believe that this amount will help recover as much as we can

from these customers. If we price Centrex service at higher rates, we can expect the customers to discontinue the service and instead purchase Dimension service. The Centrex CU equipment cannot be reused for any other service and will be "junked" if the customers disconnect because we price the service too high. In that event the burden of that equipment will be placed on other subscribers. Therefore, by pricing Centrex slightly below Dimension, we can attempt to maximize the amount these customers will contribute toward the costs of the Company. (Reinking, direct, p. 48)

153. The revenue effect for the proposed pricing of Centrex non-access is \$475, 000.

154. The Company has proposed to raise Centrex access by the same percentage as the average private branch exchange trunk, 39.93 percent, with the exception of Student Dormitory Stations which have been proposed to be increased by 74.25 percent. The annual revenue effect of re-pricing Centrex access is \$460, 000.

155. The Commission does not agree with the Company's proposal for pricing Centrex non-access. The price of an obsolete service such as Centrex should be based on original cost less depreciation plus the associated maintenance. Furthermore, noncompetitive items such as Centrex are not appropriate targets for maximizing contribution. The Company is directed to file cost studies reflecting the costing methodology put forth above. Mr. Peter Lockhart, appearing on behalf of the Residence Hall Association and the Associated Students of Montana State University, presented testimony regarding student dormitory telephone rates during the course of the hearing. It was his contention that the requested increase in rates would result in a \$30 to \$40 increase in the yearly residence hall room rates, and presented a petition containing 939 signatures requesting relief in this area. The reasoning underlying the petition is summed up by Mr. Lockhart:

I would like to add that the reason this is such a point for us is because we are having real problems at the University with the cost of just attending college. Over 60 percent of the student who attend college now receive financial aid, and it's just getting worse and worse every year. This specific area is being looked into with such concern because it was such a dramatic increase. Of course utilities in all areas are increasing and just about all the

areas the room rates are increasing. However, we just didn't feel we could watch this one go by without trying to put some input into the Public Service Commission. (Transcript, p. 835)

156. The Commission finds the re-pricing of Centrex access appropriate with the exception that Student Dormitory Rates also will rise by 39.93 percent rather than 74.25 percent. The annual revenue effect of this action is \$329,430.

#### Terminal Equipment

157. This section of this order pertains to equipment covered by Docket No. 6714 pricing methodology - the Montana Fully Distributed Cost. Equipment subject to FDC pricing includes Data service, Key, PBX, Mobile Telephone, Secretarial Bureau Service, Service Observing Equipment, Special Assemblies, Special Systems and Services, Supplemental Equipment and Telephones. Secretarial Bureau Service and other Vertical Services offerings will be addressed separately in subsequent sections.

158. In his pre-filed, direct testimony Mr. Reinking points out that the Embedded Direct Analysis study indicates that both Vertical Business and Vertical Residence services do not provide revenues in excess of their costs. He states that the goal in re-pricing these services is to cover or exceed the cost of providing these services. While Montana FDC will provide a floor in the pricing of these items, ceiling prices will be based on market demand and other factors, in many cases, in order to provide more contribution to basic exchange service.

159. One of the other factors mentioned by Mr. Reinking is the price relationship between old products and their more modern electronic replacements. He argues that, as a result of competition, and if Mountain Bell is to compete with alternative vendors, the prices of old technology equipment must rise in order to induce users of the older equipment to switch to their electronic replacements. He discusses this concept in relation to the computer industry:

The notion of inducing customers to use new technology equipment is sometimes called "migration, " a term which had its origins in the computer industry. Those familiar with the computer industry are aware of the movement of customers from the IBM 360 series of computers to the 370 series and now to the 4300 series. Customers are encouraged to move from one generation of equipment to another because the new equipment provides greater performance relative to the price which the customer must pay. Any firm participating in a market with rapidly developing technology and competition must understand migration and price its products in recognition of this reality. (Reinking, direct, p. 37)

160. Mr. Reinking justifies higher rates for older technology equipment by arguing that in the face of competition depreciation lives must be shortened:

- A. In a regulated environment with a single supplier, the use of new technology equipment is controlled by the regulators and the Company. New technology equipment can be withheld from the market place or priced at very high rates so that customers will not disconnect older equipment en masse and replace it with new equipment. In this way, abnormally long depreciation lives are created, which in turn brings lower prices. For example, if a firm purchases a truck for \$10,000 and can use that truck for 10 years for making deliveries, the price for deliveries will have to cover \$1,000 per year in order to recover the cost of the truck. If however the firm can use the truck for only 5 years, the deliveries will have to be priced high enough to recover \$2, 000 per year for the use of the truck. This assumes no resale value for the truck. Hence, the firm can price its deliveries lower if the depreciation on the truck is longer. The depreciation lines prescribed by the FCC and the state commissions in the past, have in fact done this. In competitive markets, however, it is not possible to extend the life of old technology equipment to any great degree. In fact, one of the major arguments of proponents for competition in the telephone industry, was that competition would cause a rapid development and introduction of new technology. While the rate of

development can be debated, the acceleration in the introduction of technology is clear.

Q. IN LIGHT OF THE NEW TECHNOLOGY INTRODUCTION IN THE VERTICAL TERMINAL MARKET, WHAT MUST BE DONE?

A. We must do several things to ameliorate the problem. First, we must shorten the depreciation lives on our existing equipment. These lives are prescribed by the FCC, and we have requested the lives be shortened. Early comments by the FCC indicate concurrence. Second, in order to cover the higher costs associated with the shorter lives, we must raise the price for the old technology products. Finally, if possible we should attempt to recover some of the prior under-pricing of these products. However, these steps must be taken while keeping in mind customer demand and other market factors. (Reinking, direct, pp. 35,36)

161. Finally, Mr. Reinking mentions four scenarios under which terminal equipment is priced:

A. In accordance with this Commission's order in Docket 6714 we propose to increase our other vertical terminal products so that their prices equal or exceed Montana FDC cost. In doing so, four situations arise Most of the products were priced equal to the cost. Where current rates exceeded the FDC cost they were left essentially unchanged. Third, in cases where market conditions warrant a price higher than Montana FDC costs, items of equipment were priced above the cost. Finally, for products upon which we have not been able to complete Montana FDC cost studies, an average rate case percentage of 27.98 percent increase has been applied. (Reinking, direct, p. 38)

162. Because all of the equipment discussed in this section is subject to the findings in Docket No. 6714 the Montana FDC study was applied to all items with the

exception of Special Systems and Services. Because the Company does not have current studies for these items of equipment, the overall rate case percentage was applied. The exception to this lies in Station Message Detail Recording, a service provided to the State of Montana. Mr. Reinking describes the pricing of this service:

Since the tariff says that we will change our Variable Rent to reflect increases in the aggregate cost to the Telephone Company for items such as maintenance taxes and administration, we propose to increase the Variable Rent in that manner rather than by the rate case percent. Lacking specific cost studies for this equipment we are not proposing to increase the Fixed Rents. (Reinking, direct, p. 93)

163. Included in the pricing of terminal equipment is the pricing of telephone sets. The order in the last Mountain Bell general rate case (Order No. 4585a, Docket No. 6652) disaggregated the extension telephone from the line. In this proceeding the Company has proposed disaggregation of the main station under the following schedule of prices:

Standard, single line, rotary dial	\$1. 00
Touchtone, single line	2.15
Trimline, rotary dial	3.00
Trimline, Touchtone	4.00
Princess, rotary dial	2.75
Princess, Touchtone	3.50

The Company has estimated the following revenue impact for the proposed set re-pricing:

Traditional Telephone	\$1,461,000
Princess Telephone	39,000
Trimline Telephone	<u>2,195,000</u>
Total	\$3,695,000

164. Consumer Counsel witness Wilson also provided testimony in regard to appropriate terminal equipment rates. He contends that AT&T's installed base migration policy will inevitably place an undue and excessive burden on regulated monopoly ratepayers by stranding a majority of the equipment in account 234-01, non-electric PBX:

Q. ARE THERE OTHER PROBLEMS WITH THE DEPRECIATION PROPOSALS OF MOUNTAIN BELL?

A. Yes. A similar, but even more onerous cost burden for exchange customers will result from early plant retirements in the non-electric segment of the 234 plant account. The premature retirement of this older equipment, which was installed over the 1972-1979 period, will create a substantial cost burden for Montana's basic exchange ratepayers. This burden, which occurs because of early plant retirements under AT&T's Migration Strategy prior to the time the plant is fully depreciated, will be shifted to basic exchange ratepayers under the new depreciation plan. The phenomenon occurs because an allocation of depreciator reserves to the FSS based on theoretical reserve proportions fails to give any recognition to the fact that actual "reserve" for this plant is negative. (Wilson, direct, p. 67)

165. Exactly how early plant retirements place an excess burden on basic exchange ratepayers was explained by Dr. Wilson during the course of cross-examination:

Q. You mentioned several times in your testimony that as the Computer II transition takes place, Bell will be leaving behind the cost burden of prematurely retired, older vintage equipment from monopoly exchange, from the monopoly base exchange to ratepayers. Would you explain how this comes about?

A. Okay. Let me explain it by an illustration, first.

Let's say that we have a piece of equipment with an original cost of \$100, just to make it simple, and let's say that the equipment is depreciated for rate-making purposes, for book purposes on the assumption it's got a ten-year life.

And to keep it real simple, let's assume there is no removal or salvage associated, so it's ten dollars a year is the depreciation accrual on that equipment.

If a customer adds--if that equipment is added for a customer and it remains in service for ten years, and then it's retired, the important facts are at the beginning of that period, \$100 is added for original cost, each of the ten years ten dollars was added to the accrued depreciation because it's depreciation expense.

And at the end of the ten years when the equipment is retired, \$100 is deducted from the original cost of plant because it's no longer in service, and \$100 is deducted from the accrued depreciation.

So if you started off with a total telephone plant of a thousand dollars before the \$100 was added, you wind up with a thousand dollars at the end of the ten years. You have initially added \$100 to plant, then over the ten years you have added \$100 to the accrued depreciation.

At the end of ten years, you have subtracted a hundred dollars from each account, and assuming everything else is the same, you have got a net balance of a thousand at the end.

Now let's change that assumption in one respect. Let's say that that equipment is subject to a Migration effort, or something of that nature, and instead is retired at the end of five years instead of being retained for ten years.

But at the beginning you still add \$100 to the original cost of plant, but since the equipment is only in place for five years, you over the course of its life add only \$50 to the accrued depreciation account. And therefore when that equipment is retired at the end of five years and its original cost of \$100 is deducted both from the plant account and from the accrued depreciation account, your rate base goes up by \$50. It's more than it was to begin when you started with a rate base of \$1,000.

You have added a plant of \$100 over that period and you have added accrued depreciation of \$50, and then at the end when the plant was removed, you took 100 both out of the depreciation and out of the original plant. So in effect what you did is wind up with a negative \$50 depreciation reserve .

And because you had a negative depreciation reserve, the rate base, your net plant went up.

And that's what's happened with respect to these competitive equipment accounts in the Mountain Bell jurisdiction. I can give you an example. In the State of Montana for the 234 Account, over the period of 1973 through 1979, for the 23401, that is the nonelectronic portion of PBX account. This does not include the DIMENSION or HORIZON. There were in this state, in the Montana jurisdiction, plant additions of \$7,730,000. Under the Migration Program, by the end of 1982, out of these \$7.73 million of plant additions, according to Mountain Bell's data on expected retirement for that plant, the total retirement over the ten-year period, 1973 through '82, just for those plant additions will be \$7,701,000.

Very little of that plant, only \$29,741 worth of plant will remain according to their projections in place at the end of 1982, that is the plant installed through '73 through '79.

Over that same period of time, you had depreciation accrual rates for that account originally in the 6 to 7 percent range, rising to 9.2 percent in 1979, and you had accrued depreciation expenses, that is, applying the depreciation accrual rate for the plant balance year by year, you had accrued depreciation over this ten-year period, not taking into account your depreciation that will occur in '81 and in '82 of \$2, 764, 000.

So for this plant that was added to this contract from '73 through '79, 7.7 million, almost all of it, gets retired under the Migration strategy by the end of 1982.

7.7 million gets retired, but during its life the Company accumulated only \$2.7 million of depreciation accruals. Thus, when you deduct these retirements from the original cost of plant and from the depreciation accrual, you wind up increasing your rate base by \$5 million. That was \$5 million worth of plant additions and retirement, which were costs that were incurred by the Company but which were not recaptured through depreciation accruals because the stuff had a fairly short service life, and yet it was being depreciated on the base of having a much longer service life.

And under the residual pricing approach that's used, this remains as net plant on which the Company's early return on from basic exchange ratepayers. (Transcript, pp. 1237-1242)

166. Dr. Wilson also expounded on the effect that stranding of terminal equipment has on competition:

A. Does the sale of equipment constitute an anti-competitive act? No.

Q. Well, does the lease of anti-competitive products constitute anti-competitive activity?

A. It's certainly not a per se violation of any statutory law. I think what you have to do is apply a rule of reason. And when you get into the rule of reason in antitrust jurisprudence, you have to examine the framework, the market framework within which the actions are taking place.

If you, Wally Hyer, go out and set up a leasing company or go out in partnership with Mark Clark and set up a leasing company, there's nothing anti-competitive about setting up a leasing company and going into the

leasing of equipment, telecommunications, or otherwise. But when the dominant firm on the market that has 90 percent market share and has exclusive use of a market data base that nobody else has enters into an arrangement which couples with it the ability to cross-subsidize, -- And that's very fundamental to the migration strategy; that is, the ability of Mountain Bell and AT&T to prematurely retire existing equipment and on a residual pricing basis load that uncoupled cost onto the basic exchange ratepayer and thereby subsidize through the leasing arrangement the installation of AT&T equipment so as to perpetuate this 90 percent or 85 percent market share, that constitutes an anti-competitive act and anti-competitive strategy and produces an anti-competitive end result .

So, you have to apply reason and examine the underlying facts that are related to leasing. Leasing itself is not a per se violation, but when it goes hand in hand with the type of cross-subsidies that I've talked about in my testimony, it is anti-competitive and discriminatory. (Transcript, pp. 1150, 1151)

167. In determining an appropriate price for terminal equipment, the Commission has considered several factors including the directives set forth in Docket No. 6714, the implications for Montana ratepayers in light of AT&T's migration strategy, and the nature and extent of competition for these services in Montana.

168. While the Commission remains dedicated to setting the floor at Montana FDC when pricing these services, it also finds Dr. Wilson's argument expounding the potential for severe adverse effects on local exchange subscribers compelling. In setting the FDC floor the Company uses a 17.1 percent return on equity, an overall rate of return of 14.5 percent, a periodic inflation adjustment, and includes a component to cover the cost of Specific Design and Development services furnished by Bell Laboratories. The Commission finds no fault in these factors but believes an additional component should be added to take account of the costs associated with Research and Systems Engineering (also Bell Labs ) and advice and assistance rendered by AT&T's General Department in the provision of these services. While pricing at the properly calculated FDC floor would serve

to promote competition and preclude cross-subsidization, prices far in excess of FDC, particularly in those areas not facing competition or in older vintage equipment nearing obsolescence, could tend to promote premature retirement resulting in an increased rate base burden for regulated exchange ratepayers.

169. Evidence of competition in the area of electronic PBX is clear. For older vintage equipment users, however, there is little alternative to the Bell System for the type of equipment they currently employ. The Commission recognizes that if a current Mountain Bell customer should choose to upgrade his present obsolete system he does not necessarily have to negotiate with Mountain Bell, but that is not the issue. The issue is whether to allow the Company to force retirement under migration strategy, thereby stranding undepreciated equipment with the exchange ratepayer, or to set prices at cost and recoup those costs from the causitive source of the user of the equipment.

170. While setting prices at FDC may prompt some migration anyway, the Commission finds that this approach is the most appropriate approach to making a gradual and smooth transition from the regulated to the unregulated arena, and directs the Company to establish prices for all items of equipment covered by Docket No. 6714 methodology at Montana Fully Distributed Cost; with the exception of DIMENSION and HORIZON products and telephone sets, which prices are to be set at the Company filed, December 5, 1980 levels. The revenue effect of pricing at these levels is \$7,151,752. This amount includes \$3,069,993 in net revenue to the Company and \$539,696 of Independent Co. Settlements revenue found appropriate in Amended Interim Order No. 4786a. If some terminal equipment prices are currently in excess of Montana FDC those prices are to be frozen at their current level (this freeze does not pertain to DIMENSION, HORIZON or sets.)

171. As soon as possible after issuance of this order the Company will issue a bill stuffer containing the new rates for all telephone sets. The stuffer should make it clear that customers utilizing modular jacks can switch sets at a local phone center store at no charge.

172. Furthermore, the Company is directed to file with the Commission a report detailing the number and names(s) of alternative vendors, to include the ability of these

vendors to provide maintenance and parts out of local (i. e., Montana) service centers, for all comparable categories of terminal equipment currently offered by the Company.

#### Additional Vertical Services

173. Custom Calling. Custom Calling services include Call Waiting, Call Forwarding, 3-Way Calling, and Speed Calling and are provided out of electronic switching central offices (ESS). The Company has proposed rates designed to maximize contribution and aid the Embedded Direct Analysis revenue/cost ratio for the Vertical Residence Category. The issue is uncontested .

174. Because these service offerings are associated with the latest technology in Montana and also because of their extremely discretionary nature the Commission finds this an appropriate service in which to pursue contribution and finds the proposed rates appropriate. The associated revenue effect is \$59,000.

175. Public Announcement Service. Public Announcement Service consists of equipment and facilities used to transmit information of general interest such as stock market quotations or sporting events scores. The proposed rate adjustment for this uncontested item is the overall rate case percentage .

176. As with Custom Calling services the Commission finds this service to be highly discretionary and accepts the proposed rates. The Company will file rates designed to produce an additional \$4,000 of annual revenue.

177. Directory Additional Listings. Mr. Reinking discusses the Company's proposal regarding directory additional listings:

- A. Additional listings are provided in the Telephone Directory for customers who require listing of their telephone number under more than one name. Examples of this include partners of a firm who want more than one partners name listed, duplicate listings under nicknames, and the listing of departments or divisions of a business, as is common with Centrex service.

Q. WHAT RATES DO YOU PROPOSE FOR ADDITIONAL LISTINGS?

A. The rates for additional listings have not changed since 1953. We propose to increase the rates for business additional listings from \$.75 to \$1.00 and for residence additional listings from \$.50 to \$.75. Our experience with these rates in other states indicates that the prices we propose are appropriate. This will have a revenue effect of about \$64,000 per year. (Reinking, direct, p. 52)

178. In considering this request the Commission notes that directory services are increasingly becoming more competitive and that alternative directories are in existence today. In light of this fact the Commission accepts the Company's proposal and the accompanying revenue effect of \$64,000.

Private Line

179. The Company presented Private Line service cost studies in Docket No. 6652. The Company has proposed to base rates on those same studies in the instant proceeding also.

180. Mr. Buckalew describes the nature of these studies and the effect they have on this competitive service offering:

Q. HAS THE COMPANY PROVIDED FULLY DISTRIBUTED EMBEDDED COST STUDIES FOR PRIVATE LINE SERVICE?

A. No. In the "Interexchange Channel Cost Study, " the Company assumes that private line circuits are provided over the most current technology, whether that technology is actually in place or not. The result is an understatement of costs in the interexchange segment of the market. A flowchart describing this hypothetical costing process is presented in the Cost Filing Material, Volume VI, Channel Mileage Services Section 6. The "Interoffice Channel

Study, " in contrast to the "Interexchange Channel Cost Study, " examines both the in-place investment and future investments. Although the interoffice study is an improvement over the interexchange study, elements of future technology improvements are incorporated into each. The basic problem, therefore, is that these studies give the Commission no idea of what it actually costs to provide private line service at the present time.

Q. WHY DO BELL SYSTEM COMPANIES REFLECT TECHNOLOGICAL IMPROVEMENTS IN THEIR CURRENT PRIVATE LINE COST STUDIES?

A. They do this in order to present a lower than actual cost picture to the Commission in an effort to hold down on this competitive service. Any losses, of course, are made up by charging the revenue residual to monopolized basic exchange service. In fact, the Private Line service category does not cover its costs and the Company has experienced a consistent loss on private line service since these studies were first undertaken. (Buckalew, direct, pp 47,48)

181. The cost of providing Private Line service was considered at great length in Docket No. 6652. In that proceeding the Commission found that "the cost studies performed by Mountain Bell confirm an uncontested severe underpricing of Private Line services" (Finding of Fact 130, Order No. 4585a). In that Docket the Company proposed a 102 percent increase in recurring rates and a 787 percent increase in nonrecurring rates, for a total annual revenue impact of \$2, 047, 200, in order to bring rates in line with costs. The Commission found that Private Line services should be priced to cover the cost but felt that to do so in a single move would be to abrupt a change. As a result Private Line nonrecurring revenues were increased 100 percent and recurring revenues were increased 75 percent for a total annual revenue effect of \$1,162,000.

182. Even this moderation proved to be extremely burdensome to many users and the Commission initiated Docket No. 80.10.85 to consider Private Line service exclusively. The evidence in that proceeding indicated that although subscriber intervenors agreed with

the Commission's pricing philosophy they must first be informed of pending increases in order to properly budget for expenses.

183. The Commission found that the moderation initiated in Docket No. 6552 was still appropriate and directed staff to institute rulemaking proceedings to establish requirements for the dissemination of information concerning pending rate increase applications of major regulated utilities.

184. The Commission continues to find that Private Line services are underpriced in relation to their cost. This appears to be more of a problem in the area of nonrecurring rather than recurring costs in that the nonrecurring category, considered as a whole, is currently priced at approximately 24 percent of cost whereas the recurring category is currently priced at approximately 86 percent of cost (see, for example, Exhibit No. 9A, Schedule 2, page 1 of 1, Exhibits of Kenneth V. Ishoy - prefiled). In light of this fact the Commission feels that a continued mediation towards full cost pricing in the area of nonrecurring costs is warranted at this time and directs the Company to increase these rates 100 per cent, or to 50 percent of direct cost, whichever is less.

185. Regarding recurring costs, the Commission feels that recent severe rises in these rates preclude the necessity for another sharp increase at this time. Because these services are still underpriced in relation to cost, however, it remains appropriate to move in the direction of cost, if only gradually. Consequently, the Commission directs the Company to increase the level of prices for the recurring category of Private Line costs from 86 percent to 90 percent of cost. The revenue impact of this repricing is not ascertainable at the time of this writing.

186. Regarding the appropriate cost to be covered, the Commission finds that embedded fully distributed costs, rather than prospective direct costs, more accurately reflect the responsibility of subscribers and directs the Company to provide up-to-date Private Line cost studies based on these costs .

187. Furthermore, because the Company's proposal regarding expensing of station connections did not include Private Line users the Company is further directed to

provide revenue requirements associated with expensing of station connections for Private Line subscribers.

### Local Coin

188. Regarding the provision of local coin telephone service, the Company, as outlined in the prefiled direct testimony of Mr. Marquardt, has proposed to 1 ) increase the rate for a local coin message from 10¢ to 20¢, 2) increase the rate for Collect, Third Number or Credit Card local messages from 10¢ to 50¢, when placed from a coin telephone, 3) reduce the rate of commission payments to owners or tenants of the property where public coin telephones are located from the present rate of 15 percent to 10 percent, and 4) eliminate the commission paid for semipublic telephone service.

189. Local coin calls are proposed to increase from 10¢ to 20¢ in order that the revenues from providing this service will cover the costs of providing the service. The rise to 50¢ in the local coin rate for Collect, Third Number or Credit Card calls is being proposed in order to recognize the high operator expense associated with these types of calls. Public coin commissions are proposed to fall to 10 percent to reflect the increased revenues from a rise in the price of a coin call and semipublic commissions are proposed to be eliminated in recognition of the already substantial benefits received by subscribers of this service. The revenue impact of these proposals is \$558, 637.

190. Mr. Buckalew points out in his direct testimony that the Company has not provided cost studies supporting the rate change, and suggests that a 20¢ charge for a local coin call will actually generate about 23¢ per call, since many users would not have the appropriate change and actually deposit 25¢. He also notes that a recent coin cost study in Rhode Island indicates a direct cost of about 14¢ for this type of call.

191. The Commission cannot accept the Company's proposal in the absence of current cost studies showing the cost of providing this service in Montana. Furthermore, Mr. Marquardt acknowledges that 911 (emergency calling) service is available only in some Montana exchanges. The Commission is hesitant about establishing a 20¢ charge for local coin service in the absence of universal availability of 911 service.

Wide Area Telecommunications Service (WATS)

192. The Company has proposed to revise the rate structure for WATS users and increase service rates. Mr. Marquardt outlines the rate structure revision:

The rate changes are illustrated on Schedule 2 of my Exhibit 10-A. Full Time Service at \$710 per month is being eliminated. Instead, Full Business Day Service will be offered at \$710 per month for the first 175 hours per month. The additional hourly rate is \$3.50. Measured WATS rates will go from \$276 for 15 hours per month to \$184 for 10 hours per month and each additional hour will go from \$16.50 to \$17. 20. A new concept is also being proposed whereby the number of calls placed, as well as the elapsed time, can affect the amount billed. (Marquardt, direct p. 6)

193. The new rate structure is designed to protect against abusive usage by some WATS customers in that it provides for a steady rise in the subscribers total bill for use in excess of 175 hours, and penalizes users who make an inordinate number of calls less than one minute long. Inherent in this design is the assumption that the initial minute of calling is more expensive than subsequent minutes. However, as Mr. Marquardt acknowledges, the Company has no cost support suggesting that this is the case:

Q. Inherent in your proposed rate structure for WATS is the notion that the cost of providing the initial minute of usage for this service is greater than the cost of providing additional minutes. Is there a cost study included in this application that indicates this is the case?

A. Are you talking about WATS?

Q. WATS.

A. No. The only thing that we're saying is that the first minute you have the connect expense, and once it's connected, then you should get paid for at least a minute of usage.

Q. Would you run that by me one more time?

A. There's some cost associated with connecting and setting up the call that doesn't occur for the second or third or fourth minute. If we get paid for less than a minute, then we're being underpaid. So, that we should at least recover that for the first minute.

Q. But you don't have a specific study, showing what those set- u p costs are .

A. No, I do not. (Transcript, pp. 1748, 1749)

194. The Commission finds little justification for the proposed rate structure revision and does not accept the Company's proposal at this time. The Commission does, however, recognize the responsibility of WATS users in sharing in increased operating expenses and directs the Company to increase WATS rates by the found overall percentage increase. The revenue effect of this adjustment is \$500,380.

#### Intrastate Toll

195. The Company has proposed to alter the rate structure in the provision of Intrastate Message Toll Service. Mr. Marquardt explains the current and proposed structure:

Q. WHAT CHANGES ARE YOU REQUESTING FOR INTRASTATE TOLL?

A. In the present tariffs there are initial-period rates for three different types of calls. We have one set for the first minute for direct dialed calls. There is

another set of rates for the first three minutes of operator-handled, station-to-station calls and a third set for the first three minutes of operator-handled person-to-person calls. One set of overtime rates applies to all three types of calls.

In the proposed schedule, shown in Exhibit 10-A, Schedule 1 there is one set of rates for the first minute on all calls and one set of rates for each additional minute on all calls. All intrastate long distance calls will be charged on the basis of this schedule. Instead of having separate sets of rates for different types of operator-handled calls, an operator service charge will simply be added to the basic call rate.

Q. WOULD YOU EXPLAIN THE OPERATOR SERVICE CHARGES?

A. Yes. Whereas there are now two operator handled classes of calls that bear a higher charge in the rate schedule, under the new schedule there would be three different operator service charge categories. These categories are:

- 1 ) Customer dialed station-to-station credit card calls,
- 2) Other operator-assisted station-to-station calls and
- 3) Person-to-person calls.

Credit card calls have been broken out of the overall operator-assisted call category because they are significantly less costly to handle by an operator. (Marquardt, direct, pp. 2,3)

196. Operator-assist credit card calls would carry a service charge of 30¢, other operator-assisted station-to-station calls would carry a charge of 75¢, and person-to-person calls would carry a charge of \$2.35. These rates are above their respective costs of 19¢, 50¢, and \$1.40 (Section 1, Intrastate Toll, Vol. V, Cost Filing Package) to provide the incentive to move away from discretionary, operator handled calls to lower direct dialed rates.

197. In addition, the Company is proposing to adopt the interstate mileage steps, which will result in a general decrease in the price of short haul calling. The annual revenue effect of the Company's proposal is a decrease of \$122,330.

198. In addressing the intrastate MTS service Mr. Buckalew notes that " . . . the present method of charging for intrastate operator assisted toll calls results in longer duration calls subsidizing shorter calls" (Direct, p. 56), and that the Company's proposal appears reasonable in that it " . . . will result in a closer correspondence between costs and charges. "

199. However, regarding the general level of MTS rates Mr. Buckalew recommends an additional change:

Q. DO YOU HAVE ANY OTHER RECOMMENDATIONS WITH RESPECT TO INTRASTATE TOLL SERVICE RATES?

A. Yes. The Company is proposing a change in mileage increments. The Company is not proposing to increase the rates for intrastate toll calls, but is adopting the interstate mileage steps for this service which does result in some decreases for short-haul rates. In effect, the Company is proposing a reduction in the real price of intrastate toll service.

Q. WILL YOU PLEASE EXPLAIN WHY THIS IS SO ?

A. From 1973 to 1979, the average annual increase in network access costs is reported to have been 13.9 percent. As shown in Exhibit -----(A. B . -15 ), over that same period, intrastate toll direct costs have increased by 8. 8 percent per year. Since intrastate toll service also requires network access, the Company is effectively proposing a real decrease in this service category. Since intrastate toll should be charged for access costs on the same basis as other services, in the absence of an adequate cost presentation by the Company in this case, I recommend that intrastate toll rates be increased by 10 percent. This will allow the Company to achieve

approximately \$4.5 million from these toll services to offset higher system access costs . If toll rates are not increased, the Company would effectively shift the burden of increased access line and common costs to local exchange ratepayers. In this regard, it is note worthy that AT&T and the Bell System Operating Companies have recently proposed to increase, by 16 percent, their interstate toll charges which are regulated by the FCC. (Buckalew, direct, pp. 57,58)

200. The Commission accepts the Company's recommendation regarding the rate structure revision in intrastate MTS. The revision eliminates the long duration call subsidizing the short duration call and provides for a closer matching of price with cost. Because the costs associated with operator services reflect 1978 data, the Company is directed to update the ODOD study to reflect 1981 data. The Commission also accepts the adoption of interstate mileage steps. Uniformity in mileage steps allows for a direct comparison of interstate and intrastate rates.

201. The Company has not proposed to increase intrastate toll rates in this filing. Consumer Counsel witness Buckalew has recommended a 10 percent increase. The Commission agrees that an increase in intrastate toll rates is warranted at this time. There are several reasons for this.

202. First, the Commission, in considering the Company's Embedded Direct Analysis study, does not agree that it is appropriate to place the entirety of access costs on local service. In Smith vs. Illinois Bell Telephone Company the courts held that a portion of exchange plant should be allocated to message toll service. The decision was based on "the actual use to which the property is put. " The Commission can find no logical reason for the disparity in treatment of access costs between separations procedures and the Company's EDA study, and directs the Company to provide supplemental material depicting revenue/cost ratios allocating access costs among interstate toll, intrastate toll and local exchange service, based on the actual minutes of use criteria, in all future EDA filings.

203. Second, there exists considerable evidence in the instant proceeding indicating an improper allocation of costs to competitive services in the area of the License

Contract. Because message toll is included in competitive services, any understatement of the costs associated with these services could result in an understatement of cost to message toll service.

204. Finally, in light of recent FCC decisions authorizing a 16 percent increase in interstate toll rates (FCC Order No. 81-286, Docket No. 81-412), no adjustment in intrastate rates at this time would only produce a wider gap in the already significant disparity between these rates.

205. Consequently the Commission finds it appropriate to increase intrastate toll rates in order to help meet the found revenue requirement. In this regard state toll will act as a residual category of service. Because this order directs the Company, in some instances, to increase rates in the absence of known revenue effects, the toll category will supply the balance of revenue needed to meet the found requirement for additional revenues after the effects of all other rate adjustments contemplated herein have been measured and made known. It is anticipated that toll revenues will increase by approximately \$4 million. The Company will increase toll rates on a uniform percentage basis making no adjustment for repression until such time as comprehensive price elasticity studies for the state of Montana have been submitted to the Commission.

#### Secretarial Bureau Services

206. In accordance with the Commission's order in Docket No. 6714, the Company has proposed to increase the rates for Secretarial Bureau Services by 50 percent or, if lower, to FDC.

207. However, under cross-examination by Mr. Muncy, Mr. Reinking indicates that the Company's policy towards this equipment has changed since the order in Docket No. 6714 was issued:

Q. All right. I assume, in compliance with that Order and as indicated in your testimony, it was Mountain Bell's intent to file rates for Secretary of Bureau Service Telephone Answering Service equipment at an amount which

represented a 50 percent increase over prior rates or the Montana FDC level, whichever of those two was less?

A. This is my testimony.

Q. I want to now look at exactly what you did file in this proceeding, Mr. Reinking, and I do want to discuss certain ones of the numbers with you.

But isn't it also true in the tariff that has been filed in Section 29, the Secretary of Bureau Service Tariff, you have made a new proposal that was not contained in any of the prior tariffs concerning the availability, a limit on the availability of that equipment?

A. We have added a regulation in the tariff which we filed which states that we will provide Secretary of Bureau Equipment only from available existing stock . [ sic]

Q. And that -- I am looking, Mr. Reinking, at the Fifth Revision 3 of Section 29 of the tariff, which I think you know what the note says, but you have added a note which says:

"Note: Orders will be accepted subject to the availability of the required equipment from recovered stock "

That's the addition that you are referring to?

A. Yes, that is the paragraph.

Q. And that is intended to be a limitation on the availability?

Let me ask it this way, Mr. Reinking. If Mountain Bell did not have a 557B switchboard in stock in Montana, and one of Mr. Joscelyn's and I clients desired to have a 557B switchboard, and you didn't have one in stock,

this note in the tariff, if it were allowed by the Commission, Mountain Bell is under no obligation to go buy one: is that true?

A. (No response. )

Q. And it's not your intention to buy any more of these?

A. Our intention, Mountain Bell's intention is not to buy any more. If we had -- if we had not one in stock in Montana, but we did perhaps have one in Salt Lake City, or something of that nature, we certainly would be able to go there, get one and use it without buying a new one .

Q. But the bottom line of this, isn't it, Mr. Reinking, if you don't have one in stock and can't yet one, if one of my clients needs one of those things, if this provision in the tariff is allowed, your Company can simply tell them there aren't any available and you can't have one?

A. If Mountain Bell does not have one, they do not have to go out and spend additional dollars to buy equipment and then provide it for the Telephone Answering Services at rates which cannot cover that cost.

Q. Mr. Reinking, this notice, this grandfathering obsoleting proposal, or whatever is the correct way to term it, that is a new addition to the tariff, and that proposal was not made by Mountain Bell in either Docket No. 6652 or 6714; is that correct?

A. That is true.

Q. You had - - your Company has recently made the proposal in certain other Mountain Bell jurisdictions also; is that correct?

A. Yes, we have.

Q. And in fact, you and I have sat in at least one hearing room and discussed this proposal at other jurisdictions; is that correct?

A. Yes, sir.

Q. Your testimony is limited, as you said it was. Am I correct from understanding your testimony from elsewhere, that Mountain Bell has conducted a study and has determined that they will not need to purchase any further 557B switchboards or other telephone answering equipment, and that you can, in your opinion -- in Mountain Bell's opinion, serve the needs of the Telephone Answering Services from the existing inventory and supply of that equipment which Mountain Bell has?

A. That's a true statement.

Q. Following up on that, it's been Mountain Bell's, both your belief and your intention to buy no more Telephone Answering Service 557B switchboards from Western Electric?

A. If the Commission would approve that, that would eliminate the necessity, yes, and we would not. I would hope we do not.

Q. Your, both with what your stated desire is and what the study you indicated showed about no continuing need for you to purchase these things, is it a fair statement to say, Mr. Reinking, that as far as Mountain Bell's investment goes, that that is more or less fixed at this point in time from the sense that you are not going to have to be adding any additional units?

A. Assuming that provision is approved, yes.

Q. Were the cost studies that were submitted to this Commission in connection with Docket No. 6652 and Docket No. 6714 based upon the premise that Mountain Bell would be making no additional investment, or were they

based upon the premise it was an ongoing service for which you may be required to make additional investment?

A. They were based on the then-current costs of purchasing new equipment of the 557 type.

Q. And has it been your testimony in that proceeding, in fact in numerous others, that that is the correct kind of costing methodology for a piece of equipment or a service that is being offered on an ongoing basis?

A. That is my opinion.

Q. And has it been your testimony, also, that that type of a costing methodology need not be applied if a service is grandfathered and obsoleted, and Mountain Bell is no longer required to make additional investment in a particular kind of equipment. for example?

A. Depending on the objective. If the objective is to maximize contribution and applying marginal economics, that definitely is my opinion, and I would recommend that approach.

Q. But is it true, Mr. Reinking, that for products that have been obsoleted, that Mountain Bell has oftentimes conducted what are referred to as avoidable costs studies rather than current costs studies and made pricing proposals based upon avoidable costs for an obsolete piece of gear rather than a current costs of methodology?

A. Yes, we have. That's what was entailed in the statement I just made.

Q. Mr. Reinking, my clients, Telephone Answering Services in Montana, are concerned about their ability to continue to get, for example, 557B switchboards.

In the tariff proposal which you have filed with the Commission, is there any guarantee or provisions contained in that that my clients and the Commission can rely upon that Mountain Bell will keep a certain existing stock of 557B switchboards available in Montana for use by my clients?

A. No, there is not. (Transcript, pp. 1378-1384)

208. From this dialog the Commission can conclude that the Company intends to obsolete the 557B switchboard and limit future offerings of this service. In line with previous findings in this order, the Commission directs the Company to file new cost studies on Secretarial Bureau Equipment based on original cost less depreciation plus ongoing maintenance. Also, because the 557B switchboard is the most prevalent, if not the only, switchboard in use in Montana. the Commission directs the Company to make ready a continued supply of jack strips and other parts to current users of this product.

209. As with Wide Area Telecommunications Service, the Commission further recognizes the responsibility of Secretarial Bureau Equipment users to share in periodic increases in costs to the Company and therefore, directs Mountain Bell to increase rates to Secretarial Bureau Equipment users by the found overall rate case percentage increase in revenues. This results in increased annual revenues of \$5,100.

#### Service Charges

210. Service charges apply to six separate and distinct elements in the ordering, installing, moving, changing or rearranging of telephone service. These six elements are: service ordering, the premises visit, hook-up or disconnect of the central office line, inside wiring, installation of the telephone jack, and station handling.

211. Total revenues from service charges have been increasing over several years reflecting the large increases in "churn. " It is the Company's intention to price these services in line with their associated direct costs (with the exception of the service ordering charge which is proposed to be priced below cost) in order to place the responsibility of

incurring these costs with the causative ratepayer. Consumer Counsel witness Buckalew generally agrees with the Company's pricing proposal, with the exception that costs associated with disconnect activity should be collected at the time of disconnect rather than at the time of installation.

212. The following schedule presents the current and proposed prices for some common installation activities:

<u>Service</u>	<u>Current Charge</u>	<u>Proposed Charge</u>
Reinstallation/No Modular Jack	\$17.50	\$60.30
New Service/Wiring Required	27.70	78.30
Reinstallation/Phone Center	14.50	53.45

213. During the course of this docket the Commission has received a considerable amount of correspondence from Montana consumers in response to the Company's proposed service charges. The overwhelming majority opinion is that current service charges are already high, and that the proposed charges are preposterous.

214. The Commission recognizes that service charges are currently priced below cost. Such recognition notwithstanding, however, the Commission also feels that increases in these charges could prove to be prohibitive for some individuals in need of telephone service. This problem is compounded by the fact that oftentimes those individuals that are frequently involved in moving are the same individuals least capable of paying for this service (i . e., individuals who are not homeowners ) . While the Commission remains dedicated to the notion of full cost pricing and cost cause responsibility it does not do so at the jeopardy of Universal Service concepts. Therefore, the Commission does not accept the Company's proposed Service Charges .

#### Local Exchange

215. In Montana local exchanges are currently classified into nine (9) exchange rate groups based on the total number of terminals in the exchange. This classification provides for increasing rates for both business and residential customers as exchanges grow larger. This pricing policy has been based primarily on a "value of service" concept; that is,

the greater the number of terminals in an exchange the greater the external benefits derived by any given subscriber.

216. The Company has suggested that a reduction in the number of rate groups has merit and should be considered in the future (Marquardt, direct, p. 38). The Commission has considered this proposal and not only finds merit in it but considers a reduction highly desirable. That there are currently too many rate groups is indicated by the fact that two rate groups have but a single exchange in them.

217. In revising the number of rate groups the Commission originally considered moving to three groupings, one each for small, medium and large exchanges. This grouping still gives weight to the value of service concept mentioned above. However, given the changes currently affecting the telecommunications industry, appropriate pricing should consider costs of service, rather than value of service, to a greater extent than in the past. There are indications that as a result of competition in long distance message telecommunications service local exchange rates may be placed under increasing pressure in the future. A move today to place all basic exchange subscribers on an even footing will act to ameliorate any overly burdensome shock that could arise in the future as a result of Federal and State Joint Board meetings regarding the appropriate costing and pricing of local access in the future.

218. Consequently, the Commission finds it appropriate to establish a single rate group for all 1FR and 2FR residential customers at this time. This rate revision must be considered in light of the Company's proposal to dis-aggregate the main station (for all classes of service) from the access line. This proposal consists of unbundling basic local access service into the access line and the telephone set. Prior to this proposal the charge for the standard, rotary dial set was included in the price of the local access line. Subscribers utilizing customer provided sets or a Bell System set other than the standard, rotary dial telephone were given a 70¢ credit on their bill. Customers providing their own telephone paid the tariffed local access charge less the 70¢ credit; customers utilizing a Bell System set, other than the standard, rotary dial set, paid the local access charge, less the 70¢ credit, plus a premium that recognized the higher cost associated with sets other than the standard, rotary dial set.

219. In moving to a single rate group the Commission feels that no customer should have to pay a rate higher than the currently tariffed rate in Rate Group 9, the Billings Exchange, for the local service access line. This rate is currently \$6.14 (arrived at by deducting the current set credit of 70¢ from the current access charge of \$6.84). The Commission finds it appropriate to establish the 1FR local access line rate for all 1FR subscribers at \$6.14; similarly the local access line rate for all 2FR subscribers will be \$4.75. As a result, customers subscribing to a 1FR access line and providing their own set will pay a total of \$6.14 for local service; customers subscribing to a 1FR access line and a Bell System standard, rotary dial telephone will pay \$7.14 (6.14 for the access line plus the new \$1.00 rate for standard sets) for local service. Customers subscribing to premium sets will pay a rate commensurate with the rates found appropriate in Finding No. 163.

220. Concurrently with this docket the Commission is considering Docket No. 80.10.79 - Mountain Bell's proposal for implementing the Rural Telephone Improvement Program. Because the rates for four and eight-party service are explicitly being considered in Docket No. 80.10.79 the Commission deems it appropriate to freeze four and eight-party service rates for the purposes of the present docket, and so directs the Company.

221. Regarding local exchange business rates, the Company will apply the final overall rate case revenue percentage increase to each category of business service. The derived revenue increase will then be applied uniformly across all lines in the category. The following example is provided for 2FB service:

1.	Present number of subscribers	182*
2.	Present total revenue +	\$23,100.36*
3.	Overall percentage increase	11%
4.	Increase in revenues, annually (2x3)	\$ 2,541.04
5.	Increase applied per line, annually (4 ÷ 1)	\$ 13.96
6.	Increase applied per line, monthly	\$ 1.16

\* From Inventory Book, Section 26, p. 3 of 21

+ Estimated

Application of a uniform absolute increase across all business lines within each category of business service will decrease the disparity in rates across rate groups. This result is

commiserate with the Commission's action establishing a single rate group for 1FR and 2FR customers. The revenue effect of this adjustment is not known at this time.

222. In moving to place all local exchange customers on a more even footing it is also necessary to look at the way in which customers living beyond the base rate area (BRA) are assessed for the services provided them. These customers are currently paying a mileage sensitive incremental charge. (Currently 1-party, 2-party and 4-party service rates are sensitive to the quarter-mile; 8-party (rural) rates are flat up to six miles, then increase by 50¢ for every additional four miles or fraction thereof.) Complicating the issue are a host of specially designated areas for which a separate incremental charge applies. These areas include the suburban rate area (SRA), the locality rate area (LRA), six different urban zone rate areas, and a four-party zone rate area. In general, mileage charges are computed on the basis of the airline distance from the customer's premises to the boundary of the nearest rate area or zone.

223. In order to provide greater ease of administration, greater clarity in understanding, and to advance the notion of placing all local exchange customers on a more equal footing, the Commission believes that it is beneficial at this time to replace the current method of assessing additional revenue via mileage charges with a system of zone increment charges. Current mileage charges for single and 2-party residential and business customers will be recouped by establishing three zone increments; the first increment to extend two miles beyond the base rate area, the second increment to extend four miles beyond the first increment (ending six miles from the BRA), and the third zone to include everything beyond zone two. The rates established in zone 1, zone 2 and zone 3 should be designed to reflect a 1 to 2 to 3 proportion, respectively, to as great an extent as possible. For example, the Commission staff, working from formal data requests responses submitted by the Company, has been able to determine that by assessing an incremental charge of \$2 .00 to customers in zone 1, \$4.00 to customers in zone 2, and \$6 .00 to customers in zone 3, that the current level of mileage charges is covered within less than one-half of one percent.

224. Utilizing these guidelines the Company will submit within 60 days of the effective date of this order a proposal delineating the method of establishing three zone

increments in lieu of mileage charges. The proposal should provide options retaining and deleting the present various rate zones and areas. The tariffs necessary to implement the Company's proposed method should accompany the filing. In the interim the Company will continue to implement mileage charges as it has done in the past.

225. Finally, because the question of what it actually costs to provide local exchange service is an issue of paramount concern to state regulators today, the Company is directed to begin preparing a proposal for the development of fully distributed costs in the area of local exchange. This issue will be carefully scrutinized within the confines of the next general rate case. In the interim the Commission urges the Company, Commission staff, and the office of the Montana Consumer Counsel to institute a series of three-way meetings in which the issue of the appropriate FDC methodology may be discussed. The initial meeting regarding this issue may be set at the initiative of any one of the parties involved.

#### Reconciliation of Revenue Requirement

##### with Revenue Generation

226. The revenue requirements portion of this order established a need for increased revenues, to include toll settlements, of \$13,887,898. The tabulation below sets forth the total revenue requirement and the areas of revenue generation found appropriate to cover that requirement. All requests for rate adjustment not specifically addressed in this order are hereby denied.

Revenue Requirement/Generation	
Revenue Requirement	\$11,762,000
Settlements	<u>2,125,898</u>
Total	<u>\$13,887,898</u>
Directory Assistance	\$ 556,993
Centrex Access	329,430
Terminal Equipment 1	7,151,752
Custom Calling	59,000
Public Announcement Service	4,000
Directory Additional Listings	64,000

TAS	5,100
WATS	500,380
Private Line 2	
Local Exchange 2	5,339,573
State Toll (Rate Increase) 2	
State Toll (Restructure)	<u>(122,330)</u>
Total	<u>\$13,887,898</u>

- 1 Includes an interim adjustment of \$3,069,993 in net additional revenues and \$539,696 in Independent Co. toll settlements .
- 2 The revenue effect of rate revisions for these categories of service is undeterminable at the time of this writing. The total revenue impact must be \$5,339,573 in order to balance the revenue requirement with revenue generation.

227. Because the toll settlement figure is an approximation estimated by the Company prior to having the full information provided by this order, the Company will re-compute the toll settlements figure following receipt of this order. Any significant alterations in the toll settlements figure will be considered for appropriate action at the time of filing of the revised figure. Also, the Company will file revenue generation figures based on its interpretation of this order for all categories of service affected herein.

### CONCLUSIONS OF LAW

1. Applicant, Mountain States Telephone and Telegraph Company is a corporation providing telephone and other communication services within the state of Montana and as such is a "public utility" within the meaning of Section 69-3-101, MCA .
2. The Montana Public Service Commission properly exercises jurisdiction over the Applicant's Montana operations pursuant to Title 69, Chapter 3, MCA.
3. The rate base adopted herein reflects original cost depreciated values and as such complies with the requirements of Section 69-3-109, MCA, that the value placed upon a utility's property for rate-making purposes "...may not exceed the original cost of the property."

4. The rate of return allowed herein through the application of the direct double leverage approach meets the constitutional requirement that a public utility's return must be "commensurate with returns on investments in other enterprises having corresponding risks and sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital. " Federal Power Commission v. Hope Natural Gas Company, 320 U. S. 591, 603 (1944).

5. The rate structure authorized by the Commission herein is just, reasonable and not unjustly discriminatory, Section 69-3-201, M CA.

6. The Commission has the authority to inquire into the management of the business of Mountain Bell including such areas as depreciation methods and is required to keep itself informed as to the manner and method in which the same is conducted, Section 69-3-106(1), MCA.

### ORDER

#### THE MONTANA PUBLIC SERVICE COMMISSION ORDERS THAT:

1. The Mountain States Telephone and Telegraph Company shall file rate schedules designed to produce a test year revenue increase of \$13,887,898 from its Montana subscribers. This increase is in lieu of rather than in addition to that granted on an interim basis in Order Nos. 4786a and 4786b .

2. The increased revenues authorized herein shall be collected from tariffed services in the manner described in the Findings of Fact of this Order .

3. The increased rates authorized herein shall be effective upon the filing and approval of revised tariffs consistent with this Order.

4. Mountain Bell in its next general rate case filing is to present therewith:

- a) Current fully distributed cost studies for the provision of local exchange service,
- b) Current fully distributed cost studies for the provision-of private line services,
- c) Cost studies based upon "original cost less depreciation plus maintenance" for Centrex and Secretarial Bureau Service,
- d) Detailed documents listing each BIS project for which the Company has been billed, the amount of expense associated with each project, an indication of whether or not the particular project has been implemented in Montana, and if implemented a full explanation of how that project benefits the Montana ratepayer,
- e) A listing of all Case Authorizations and Budget Decision Packages utilized during the test year in Montana, accompanied by an explanation of how that Case Authorization or Budget Decision Package benefits Montana ratepayers and the extent to which it is competitively related,
- f) Consistent with the Commission's concern expressed in Finding No. 28, Mountain Bell should present the methodology employed in determining the prices that it pays to Western Electric for equipment. The presentation should include breakdowns of several representative equipment items . The Commission will also require a showing of Western Electric's capital structure and its most recent return on equity.

5. Mountain Bell shall file with the Commission a report detailing the number and names of alternative terminal equipment vendors in Montana. The report should include information on the extent to which the alternative vendors are capable of providing maintenance and parts locally (i. e., Montana service centers) for all categories of terminal equipment comparable to that offered by Mountain Bell. All Mountain Bell

filings for approval of new terminal equipment or for grandfathering or obsoleting old equipment should also include similar information concerning the availability of comparable equipment by alternative vendors.

6. Mountain Bell shall maintain a supply of jack strips and other parts necessary for the continued operation of currently in-place 55 7B switchboards in Montana.

7. Mountain Bell shall issue a bill stuffer to all customers currently leasing standard rotary dial, trimline, Touchtone or princess telephone sets. The stuffer will point out to the customers the increased rates for these sets and advise them that they have the option of changing to a less expensive set or of purchasing their own set from a competitive vendor. The form of the stuffer must receive prior approval from the Commission and will be issued as soon as possible .

8. Mountain Bell shall also issue a bill stuffer concerning the directory assistance charging plan as directed in Finding No. 150.

9. Mountain Bell is directed to cooperate with the Commission staff and the Montana Consumer Counsel in an attempt to arrive at mutually agreeable fully distributed costing methodologies in the areas of local exchange and private line services.

10. Within 60 days following service of this order Mountain Bell shall file alternative proposals to implement the zone increment charges outlined by the Commission in Finding Nos. 218-224. The proposals shall include alternative methods of dealing with suburban rate areas (SRA's) locality rate areas (LRA's ) and urban zone rate areas .

11. The Commission staff shall establish a docket to consider on an expedited basis the need for increased revenues regarding Mountain Bell's 1981 wage and salary increases. The scope of the docket shall include the concerns expressed in Finding of Fact No. 118.

12. All motions and objections made by the parties in this docket which were not ruled upon by the Commission at the hearing or earlier in this order are hereby denied.

Done and Dated this 11th day of September, 1981, by a vote of 5-0.

BY ORDER OF THE MONTANA PUBLIC SERVICE COMMISSION.

GORDON E. BOLLINGER, Chairman

JOHN B. DRISCOLL, Commissioner

HOWARD L. ELLIS, Commissioner

CLYDE JARVIS, Commissioner

THOMAS J. SCHNEIDER, Commissioner

ATTEST:

Madeline L. Cottrill  
Secretary

(SEAL)

NOTE: NOTE: You may be entitled to judicial review of the final decision in this matter. If no Motion for Reconsideration is filed, judicial review may be obtained by filing a petition for review within thirty (30) days from the service of this order. If a Motion for Reconsideration is filed, a Commission order is final for purpose of appeal upon the entry of a ruling on that motion, or upon the passage of ten (10) days following the filing of that motion. cf. the Montana Administrative Procedure Act, esp. Sec. 2-4-702, MCA; and Commission Rules of Practice and Procedure, esp. 38.2. 4806, ARM.